DOCUMENT RESUME

ED 326 144 HE 024 046

TITLE	Guaranteed Student Loans: Profits of Secondary Market Lenders Vary Widely. United States General Accounting Office Briefing Report to Congressional Requesters.
INSTITUTION	General Accounting Office, Washington, D.C. Div. of Human Resources.
REPORT NO	GAO/HRD-90-130BR
PUB DATE	Sep 90
NOTE	73p.
AVAILABLE FROM	U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20877 (first five copies free; additional copies $2.00 each).
PUB TYPE	Reports - Evaluative/Feasibility (142)
EDRS PRICE	MF01/PC03 Plus Postage.
DESCRIPTORS	*Banking; Educational Finance; Federal Programs; Higher Education; Interest (Finance); Investment; State Agencies; *Student Loan Programs
IDENTIFIERS	Profit Making; *Profits; *Stafford Student Loan Program; Student Loan Marketing Association

ABSTRACT

This report was prepared to determine lenders' rates of return or profitability on Stafford loans in their portfolios, reasons for varying levels of profitability among institutions that hold such loans, and the effect of 1986 subsidy reductions on these lenders' profitability. The study focused on the activities of lenders that purchase Stafford loans in the secondary market. Ten major loan holders in the three main kinds of secondary markets for student loans were studied: (1) commercial banks (Chase Manhattan Bank and Wachovia Bank and Trust Company); (2) the federally chartered secondary market (the Student Loan Marketing Association); and (3) state-level agencies or institutions in California, Colorado, Indiana, Nebraska, Pennsylvania, and Virginia as well as the New England Education Loan Marketing Corporation which serves four states. The study found that annual after-tax rates of return varied considerably during fiscal year 1985-88 among and within the institutions. The Student Loan Marketing Association, the two commercial banks, and the Indiana agency were profitable during each of the 4 years. Profit variations were due primarily to differences in the lenders' financing, servicing, operating, and other costs. The 1986 subsidy reductions had little effect on lenders' revenues. Appendices describe the study methodology, display data supporting the report's figures, and present comments from the financial institutions examined. (JDD)

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-235076

September 28, 1990

The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

The Honorable Augustus F. Hawkins
Chairman, Committee on Education
and Labor
House of Representatives

The federal government subsidizes higher education loans to students. In fiscal year 1988, federal interest subsidies for Stafford student loans (formerly Guaranteed Student loans) were about $2.2 billion. Lenders, such as banks, savings and loan associations, and credit unions, make below-market rate loans (generally 8 percent) to students and bill the federal government for the interest subsidies.

In 1986, when the Congress reduced the federal subsidy rate by 0.25 percent for most new loans, lenders warned that resulting profit reductions would make the guaranteed loans unattractive investments. To provide a better basis for determining the appropriate subsidy rate on student loans, you requested us to determine

- the lenders' rates of return or profitability on Stafford loans in their portfolios,
- the reasons for varying levels of profitability among institutions that hold such loans, and
- the effect of the 1986 subsidy reductions on these lenders' profitability.

As agreed with your offices, our report focuses on the activities of lenders that purchase Stafford loans in the "secondary market." These lenders purchase the loans from originating lenders (those that made the loans), thereby providing them money to make new loans. Originating lenders' portfolios may contain many kinds of loans—such as home mortgages, auto loans, and credit card receivables. In contrast, many lenders in the secondary market either deal almost exclusively with student loans or separately account for their student loan activities. While secondary market lenders may not be representative of originating lenders, they are more likely to maintain the financial data we needed to determine the profitability of their student loan business.

We judgmentally selected 10 institutions that are major loan holders in the three main kinds of secondary markets for student loans:

- Commercial banks—Chase Manhattan Bank and Wachovia Bank and Trust Company.
- The federally chartered secondary market—the Student Loan Marketing Association, known as Sallie Mae.
- State-level agencies or institutions—the California, Colorado, Indiana, Nebraska, Pennsylvania, and Virginia agencies, and the New England Education Loan Marketing Corporation (Nellie Mae), which serves four New England states.

The banks and Sallie Mae are for-profit institutions; the state institutions are not.[1] Information that lenders reported to the Department of Education indicates that these 10 institutions held (1) about 34 percent of all Stafford loans outstanding at the end of fiscal year 1988 and (2) made about 71 percent of all secondary market purchases of Stafford loans during the year.

The Congress has changed the level of interest subsidies paid to lenders several times since the inception of guaranteed student loan programs in 1965. Effective October 1, 1980, the subsidy for lenders using financing for which interest is taxable was set at the difference between the interest rate paid by students—generally 8 percent—and a rate 3.5 percent above the yield on 91-day Treasury bills. Subsidy levels for Stafford loans financed from tax-exempt sources on or after that date were set at one-half of the subsidy for taxable financed loans, provided total interest paid to lenders was at least 9.5 percent.

In 1986, the Gramm-Rudman-Hollings budget sequester temporarily reduced the subsidy rate factor for new loans made between March 1 and September 30, 1986, from 3.5 to 3.1 percent. The reduction applied to the first four quarterly subsidy payments for each loan. Subsequently, the Higher Education Amendments of 1986 set the subsidy rate factor at 3.25 percent for new loans made after November 15, 1986, with funds obtained from taxable sources. Subsidies for loans purchased with tax-exempt funds were not affected by either of the 1986 revisions.

[1] Although some of the institutions we reviewed are nonprofit entities and do not earn "profits" as such, we use the term "profitability" of student loans as the difference between income earned on the loan portfolios and the costs associated with financing and servicing the loans, the costs of operating the agency, and applicable taxes

We analyzed records obtained from the Department and the 10 institutions for the four fiscal years 1985-88, and interviewed Department and lending institution representatives and other knowledgeable parties. We conducted our work between January 1988 and February 1990 in accordance with generally accepted government auditing standards. A more detailed description of our methodology is in appendix I.

Results of Our Analysis

Annual after-tax rates of return varied considerably during fiscal years 1985-88 among and within the institutions we reviewed. Sallie Mae, the two commercial banks, and the Indiana agency were profitable during each of the 4 years. Five other secondary market lenders experienced losses in at least one year during the period.[2] The Pennsylvania agency had losses in all four fiscal years, while the other four lenders had annual rates of return ranging from a profit of 1.24 percent of their outstanding Stafford loan portfolios to a loss of 3.31 percent. (See pp. 21-25.)

In 1988, secondary market lenders' net rates of return varied within a range of 4.26 percentage points of outstanding loans. Profit variations were due primarily to differences in the lenders' financing, servicing, operating, and other costs, which varied within a range of 3.86 percentage points. In contrast, gross revenues as a percentage of outstanding loans varied by only 1.35 percentage points. The 1986 subsidy reductions have had little effect on lenders' revenues to date.

The variations in profitability among lenders indicate that revenue and cost information does not provide a sufficient basis for determining appropriate subsidy levels. In fact, profitability by itself is not the only determinant of lender participation. The loan portfolios of all but 1 of the 10 institutions increased over the 4-year period, including the holdings of 4 agencies that were unprofitable in at least one of the years. These not-for-profit agencies were established for such purposes as serving as a secondary market for all lenders in their service areas by purchasing all loans offered without regard to risk or potential profitability.

[2] Colorado provided cost information, but did not provide other information needed to compute profitability

Cost Variations Significantly Affected Profitability

The institutions' financing costs, principally interest, accounted for about 76 percent of total costs in 1988. Costs as a percentage of outstanding loans varied within 1.34 percentage points. The factors affecting their financing costs included the timing, maturity, and mix of taxable and tax-exempt financing, and the mix of fixed and variable rate financing.

Costs unrelated to financing—servicing, operating, and other costs—varied by 3.71 percentage points in fiscal year 1988. Those costs were lowest for Sallie Mae (1.42 percent) and highest for the California agency (5.13 percent). The higher costs at several institutions were due in part to unique events or circumstances. For example, California's 1988 costs included a provision for future losses on delinquent loans of 3.34 percent—the agency may incur significant losses if the Department of Education or the state guaranty agency[3] determines that certain of its delinquent loans were not properly serviced and refuses to pay default claims. The Colorado agency's 3.58-percent rate was caused in part by expenses related to its transition from in-house servicing of loans to a contract arrangement.

Interest Subsidy Variations Had Little Effect on Profitability

The 1986 reductions had little, if any, effect on the institutions' profitability, primarily because they applied to only a small portion of their 1988 outstanding loans. The Gramm-Rudman-Hollings budget sequester reduction in the subsidy rate was temporary and applied only to new loans made between March 1 and September 30, 1986. The reduction to 3.25 percent required by the Higher Education Amendments of 1986 applies only to loans made after November 15, 1986, and financed with taxable funds. On average, these changes applied to about 18 percent of the Stafford loans held by the 10 institutions at the end of fiscal year 1988.

We estimate that the maximum reduction in overall profitability for any institution was 0.1 percent of outstanding loans in 1988. The reductions had no effect on the Colorado and Pennsylvania agencies, which relied entirely on tax-exempt financing during the year. However, for some institutions in some years, the reductions could be significant. For example, the reduction for one agency was 0.1 percent of outstanding loans compared to its rate of return for that year of 0.29 percent.

[3] Borrowers' interest and loan principal payments are guaranteed by guaranty agencies, which are in turn insured by the Department.

6

The 1986 subsidy reduction of 0.25 percent can be expected to reduce revenues more in the future as (1) loans subject to the lower subsidy rate make up more of the taxable funded portions of portfolios and (2) state limits on the use of tax-exempt debt cause state agencies to rely more on taxable borrowing. However, the effect of the subsidy reduction on the institutions' profitability will likely continue to be minor compared with the effect of variations in financing, servicing, and other costs. (See p. 28.)

Loans Financed With Tax-Exempt Funds Can Earn More Revenue Than Other Loans

Agencies that use tax-exempt funds to purchase Stafford loans at times earn higher interest revenues than do lenders using taxable funds to finance their loan portfolios because:

- The 1986 reduction of 0.25 percent in the subsidy rate factor did not apply to student loans made or purchased with tax-exempt funds, which continue to receive subsidies at the pre-1986 level. At the end of fiscal year 1988, such loans accounted for about 55 percent of the Stafford loan portfolios of all seven state secondary market institutions studied.
- The Higher Education Act provides loans purchased with tax-exempt funds a minimum rate of return of 9.5 percent. In periods of relatively low interest rates, lenders receive higher rates of interest on these loans than on loans made or purchased with taxable funds that are not protected by an interest rate floor. For example, during fiscal year 1986 the gross return on tax-exempt financed loans remained at the floor of 9.5 percent, while the return on taxable financed loans to first-time borrowers ranged from 8.75 to 10.88 percent. (See p. 26.)

Eliminating the 9.5-percent revenue floor and reducing the subsidy rate factor on tax-exempt financed loans to 3.25 percent would be consistent with the treatment of loans financed with taxable funds and would reduce federal interest subsidies. However, such actions would reduce revenues of state-level agencies, which included the least profitable institutions in our study.

Agency Comments

The Department of Education and 9 of the 10 secondary market lenders we reviewed provided written comments on a draft of this report. The Department and several of the institutions provided technical comments, which we incorporated where appropriate. Several lenders also noted that the institutions vary widely in their operations and profitability, and some advised us that their costs have increased since the completion of our study. Our evaluation of their comments begins on page 36. Their comments appear in appendixes III through XII.

We are sending copies of this briefing report to the Department of Education, other congressional committees, and other interested parties. Should you wish to discuss its contents, please call me on (202) 275-1793. Major contributors to this report are listed in appendix XIII.

Franklin Frazier

Franklin Frazier
Director, Education
and Employment Issues

8

Contents

Tables

Figures

11

12

Profitability of Stafford Student Loans Held by Secondary Markets Varied Widely

Objectives

The costs of federal interest subsidies for guaranteed student loans rose from $1.3 billion in fiscal year 1980 to $3.3 billion in fiscal year 1985. In 1986, the Congress reduced the interest subsidy rate by 0.25 percent for most new loans. At that time, some lenders indicated that the reduction would make student loans unattractive. To assess the profits lenders were making on these loans and to provide a basis for assessing the adequacy of federal interest subsidies, the House Committee on Education and Labor and the Senate Committee on Labor and Human Resources asked us to determine (1) the profitability of Stafford loan portfolios held by major secondary market institutions receiving federal interest subsidies on these loans, (2) the reasons for variations in the profitability of these portfolios, and (3) the effect of the 1986 reduction in the interest subsidy rate on their profitability. (See fig. 1.)

After discussions in early 1988 with the committees, we focused our efforts on the profitability of Stafford loan portfolios of those lenders that make up the secondary market for student loans, that is, financial institutions that purchase Stafford loans from banks, savings and loan associations, credit unions, and other financial institutions that make loans to students. In contrast to the originating lenders, whose portfolios may contain many kinds of loans—such as home mortgages, auto loans, and credit card receivables—many lenders in the secondary market either deal almost exclusively with student loans or separately account for their student loan activities.

13

Figure 1

GAO **Objectives**

- Determine profitability of student loans
- Examine variations
- Determine effect on profits of 1986 interest subsidy reduction

Scope and Methodology

At the beginning of our review, we held a conference with secondary market officials and others knowledgeable in student loan finance as we developed our review methodology. We also contracted with an expert on government-sponsored enterprises to identify and describe the legal and institutional factors that affect the three major kinds of institutions that make up the secondary market for Stafford loans—commercial banks, state agencies, and the federally chartered Student Loan Marketing Association (Sallie Mae)—and their reasons for participating in the secondary market for student loans. (See fig. 2.)

Figure 2

GAO **Methodology**

- Held conference with major loan purchasers to discuss review approach
- Used consultant to identify and assess factors affecting competitiveness among purchasers
- Analyzed financial activities of 10 major purchasers

We focused on the activities of 10 judgmentally selected Stafford loan secondary market institutions that were major loan holders during fiscal years 1985-88. At the end of fiscal year 1988, secondary market institutions held about two-thirds of all Stafford loans. The 10 we analyzed held about $13.5 billion, or one-third of all Stafford loans, and made about 71 percent of all reported secondary market purchases during fiscal year 1988. (See fig. 3.)

15

Figure 3

GAO Reviewed 10 Secondary Markets

- Sallie Mae
- Commercial banks
  - Chase Manhattan
  - Wachovia
- State agencies
  - Designated not-for-profit (CA, IN, NE, Nellie Mae)
  - Government agencies (CO, PA, VA)

They represent the three major kinds of secondary market institutions:

- The federally chartered Student Loan Marketing Association (Sallie Mae) is a stockholder-owned, for-profit corporation, established by the Congress as a national secondary market for federally guaranteed student loans. With a portfolio of about $9.4 billion of Stafford loans at the end of fiscal year 1988, Sallie Mae is by far the largest holder of these loans.
- Commercial banks are stockholder-owned, for-profit lending institutions. We selected two banks that, in addition to purchasing Stafford

loans, were also major originators of such loans. Chase Manhattan Bank[1] and Wachovia Bank and Trust Company together held $1.1 billion of Stafford loans at the end of fiscal year 1988.

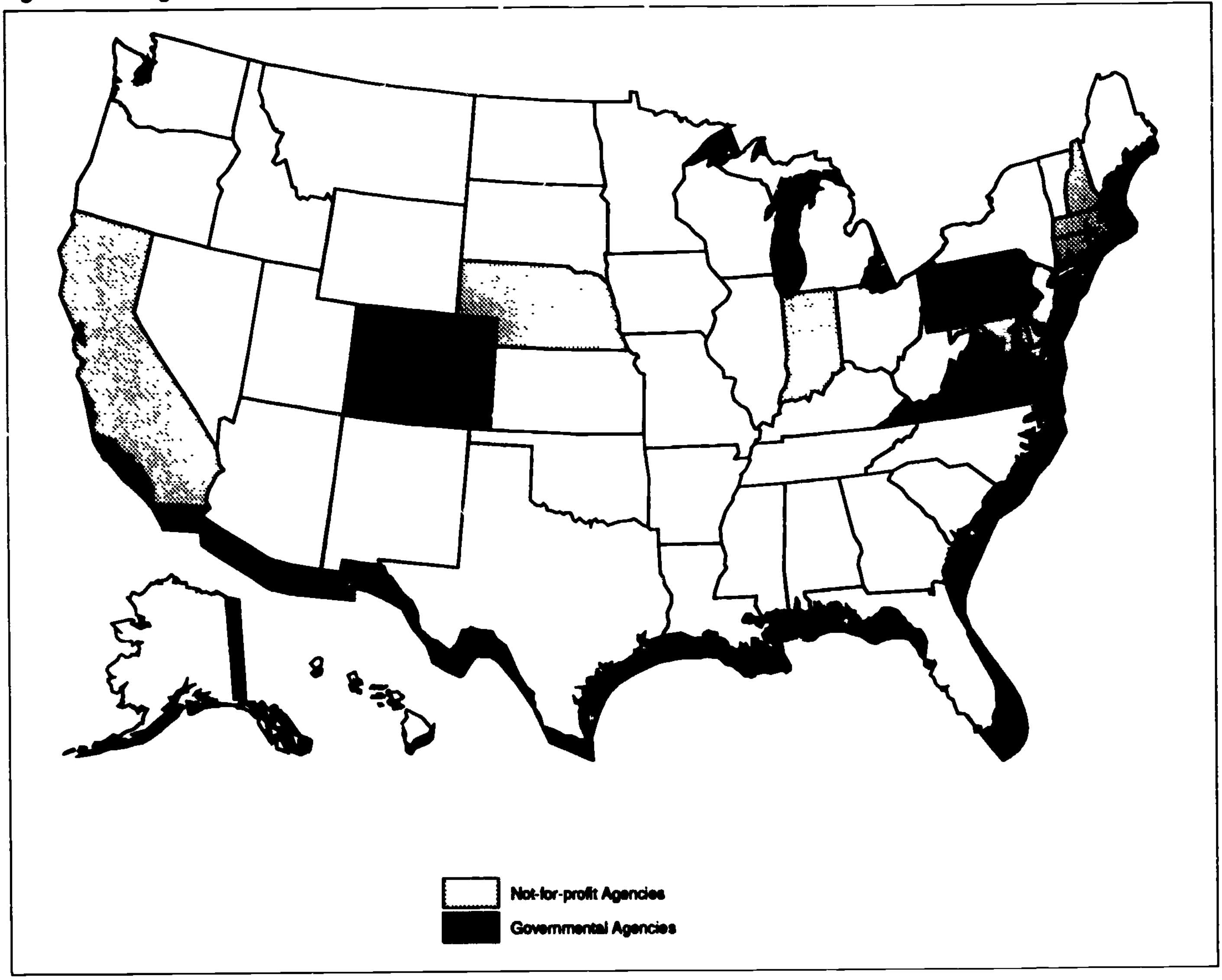
- State agencies are either governmental or not-for-profit agencies. They purchase student loans from private lenders, often for resident-borrowers of the states in which they were established. A principal feature that differentiates them from other secondary lenders is that they may use tax-exempt financing to purchase Stafford loans. We selected seven state agencies to provide a cross-section of the different types of state secondary markets. Three of these are private, not-for-profit agencies that serve single states (California, Indiana, and Nebraska); one is a private, not-for-profit agency that serves Massachusetts, New Hampshire, Connecticut, and Rhode Island (New England Education Loan Marketing Corporation, or Nellie Mae); and three are state governmental agencies that serve single states (Colorado, Pennsylvania, and Virginia). (See fig. 4.)

To determine Stafford loan profitability for the 10 institutions in each of the four years during the 1985-88 period, we analyzed their Stafford loan costs and revenues expressed as a percentage of the average balance of their outstanding Stafford loan portfolio for each year.[2] Although the seven state agencies do not generate "profits" as such, we use the terms "profit" and "loss" to refer to each of the 10 institutions' net rates of return on Stafford loans (net income or loss as a percentage of the average balance of outstanding Stafford loans).

[1]We excluded from our analysis Stafford loans held by Chase Lincoln First Bank and Chase Manhattan, St. Thomas.

[2]Colorado provided cost data, but did not provide other data needed to compute profitability

Figure 4: State Agencies Reviewed



18

Figure 5

GAO

How Profitability Is Calculated

Gross revenues

Less costs:
- Cost of funds
- Servicing costs
- Operating costs
- Taxes, where applicable

Equals profitability, or net rate of return

Revenues to lenders, whether they make loans or purchase them in the secondary market, consist mostly of interest paid by students and interest subsidies paid by the Department of Education. Borrowers' interest and loan principal payments are guaranteed by 1 of 59 state or nonprofit guaranty agencies, which are in turn insured by the Department. The federal interest subsidies include (1) students' interest while they are in school and during grace and deferment periods after they leave and (2) an additional subsidy, referred to as a special allowance payment, throughout the life of the loan that is intended to give lenders a near-market interest rate.[3]

Secondary market lenders incur costs to borrow the funds to purchase and service loans and to pay operating and other expenses.

- Costs of funds include lenders' interest expenses and other costs of issuing debt, such as letters of credit, underwriting, and bond attorneys' fees.
- Servicing costs include the costs of billing, collecting, and accounting for loan payments; encouraging borrowers to make scheduled payments; and filing claims with the guaranty agency when students default. Some lenders service their own loans, while others contract for the servicing of all or a portion of their portfolios.
- Operating and other costs include administrative costs and provisions for loan losses.

To calculate profits for Sallie Mae and the two commercial banks, we also deducted taxes from revenues. To facilitate comparisons among agencies, we included in our analyses only revenues and costs directly associated with the Stafford loans held by each. We excluded, for example:

- Arbitrage revenues that state agencies earned by issuing tax-exempt securities and temporarily investing portions of the proceeds in higher yielding investments until they purchase student loans.
- Revenues that Wachovia and the Colorado, Indiana, and Pennsylvania agencies, or their affiliates, received for servicing loans held by other lenders.
- Revenues that Sallie Mae earned from sales of letters of credit and loans it made to facilitate other lenders' student loan programs.

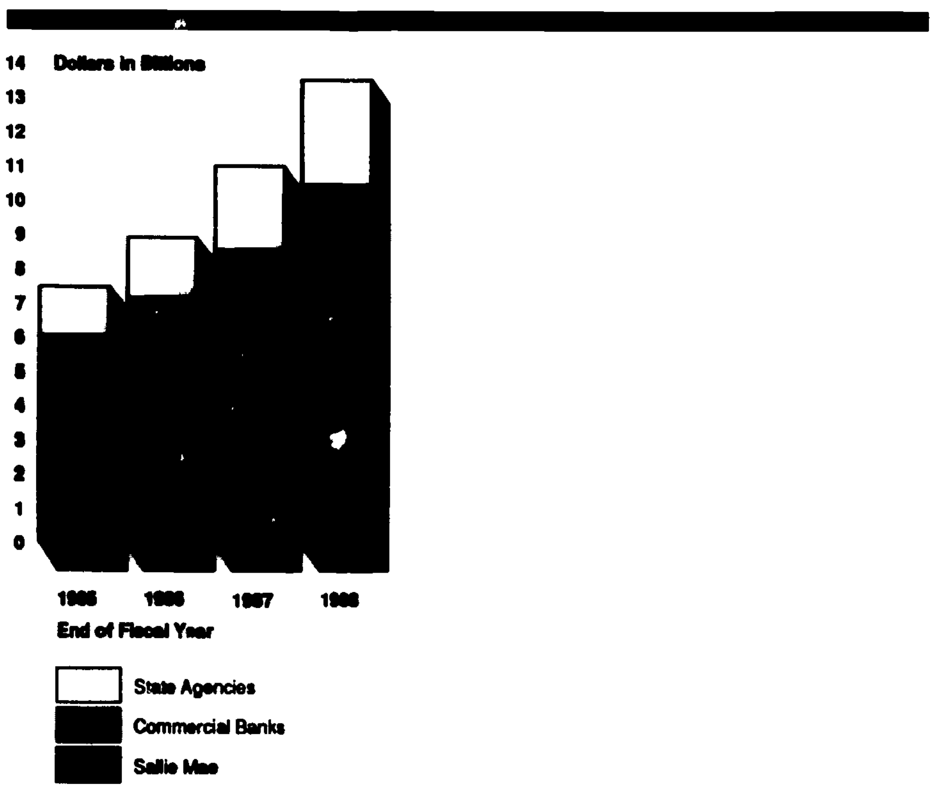
In addition, some of the 10 institutions failed to provide all of the data we requested. A complete description of our methodology, including data limitations, is in appendix I.

[3]The interest rate students pay has been 8 percent on loans to first-time borrowers since 1983. For students borrowing Stafford loans for the first time after June 1988, interest will increase to 10 percent after the fourth year of repayment. The special allowance is paid quarterly and, for taxable financed loans, is the difference between the borrower's interest rate and the average bond equivalent rate on 91-day Treasury bills plus 3.25 percent.

The 10 Institutions' Loan Holdings Have Increased

The 10 institutions we reviewed were among the 40 largest holders of guaranteed student loans at the end of fiscal year 1988.[4] As shown in figure 6, their outstanding Stafford loans rose from $7.4 billion at the end of fiscal year 1985 (22 percent of all outstanding loans) to $13.5 billion at the end of fiscal year 1988 (34 percent). Sallie Mae was by far the largest holder. Its $5.1 billion student loan portfolio at the end of fiscal year 1985 increased to about $9.4 billion at the end of fiscal year 1988. Four other institutions reviewed were among the 10 largest holders of guaranteed student loans at the end of fiscal year 1988—Nellie Mae, Chase Manhattan, and the Nebraska and California agencies.

Figure 6: Ten Institutions' Loan Holdings Doubled (Fiscal Years 1985-88)



Note: Excludes many of the Pennsylvania agency's Stafford loans (for example, $340 million for 1988) that—while federally insured—were ineligible for federal interest subsidies principally because the borrowers' incomes exceeded federal maximums

[4]At that time, about $40 billion of the $45 billion of outstanding guaranteed student loans were Stafford loans.

21

As discussed in more detail below, net rates of return varied widely among nine institutions during the 4-year period. However, profitability was apparently not the only factor influencing lenders' continued participation in the program. As shown in table 1, of the five agencies that reported losses in at least one year during the period, four increased their loan portfolios substantially while one reduced its portfolio slightly. Each of the lenders that had losses are not-for-profit or state agencies generally established for purposes other than making profits. Some of the reasons for which these lenders were created include (1) to serve all lenders and borrowers in their service areas regardless of the costs and risks of certain kinds of loans and (2) to purchase loans that lenders have difficulty selling to for-profit secondary market institutions.

Table 1: Stafford Loan Holdings Generally Increased Despite Unprofitable Operations (Fiscal Years 1986-88)

Institution	Years unprofitable[a]	Loan holdings change (percent)
Sallie Mae	None	82
Chase Manhattan	None	11
Wachovia	None	135
California	1988[b]	196
Indiana	None	48
Nebraska	1985	230
Nellie Mae	1985-86	258
Pennsylvania	1985-88	408
Virginia	1987-88	−8

[a]California and Chase Manhattan data are for calendar years

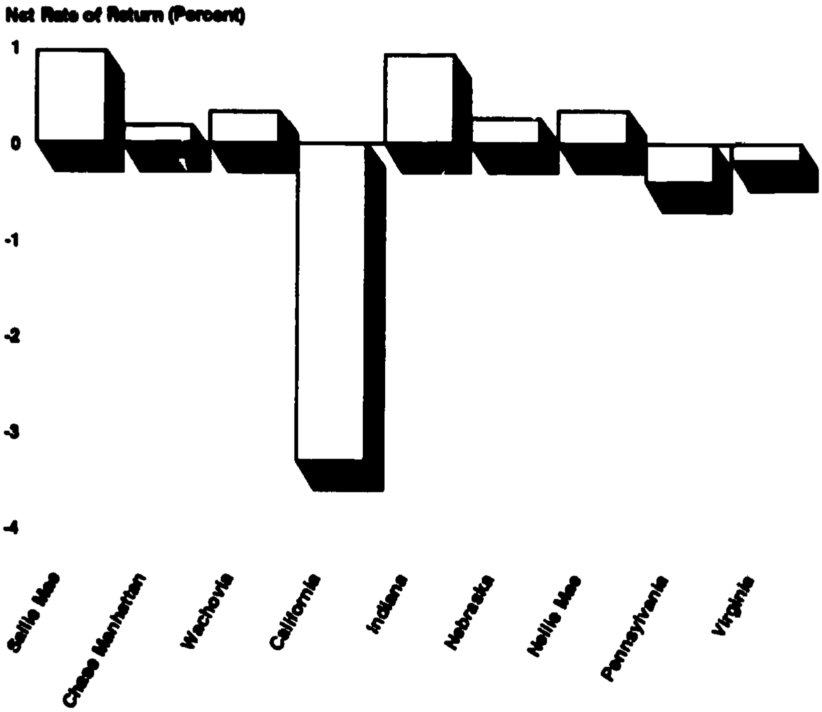
[b]No data on profitability for fiscal years 1985 and 1986

Profitability Varied Widely Among Secondary Market Lenders

The variations in profitability among the institutions were more often a result of differences in costs than in revenues. In 1988,[5] for example, net rates of return varied within a 4.26-percentage-point range, from a 3.31-percent loss to a 0.95-percent profit. (See fig. 7.) However, gross revenues as a percentage of outstanding loans varied by only 1.35 percentage points (9.03 to 10.38 percent). Costs as a percentage of outstanding loans varied over a broader, 3.34-percentage-point range (9.00 to 12.34 percent).

[5]The California agency and Chase Manhattan data are for calendar year 1988. All other data are for the fiscal year ending September 30, 1988.

Figure 7: Nine Institutions' Profitability Varied Widely in 1988



Note. Data not available for the Colorado agency

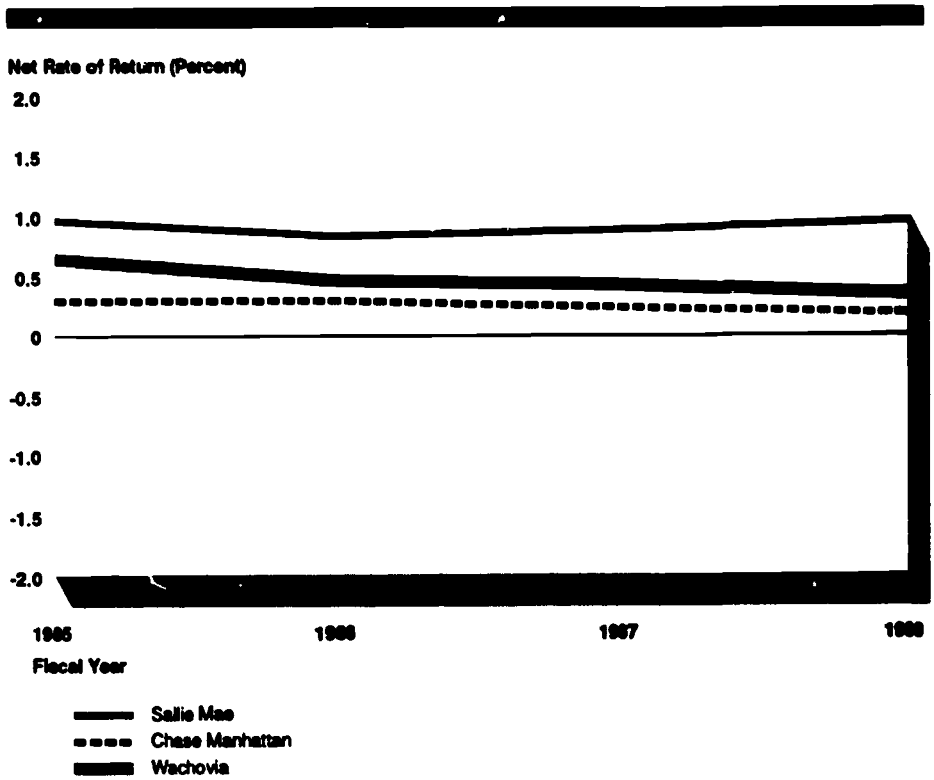
Among profitable lenders in 1988, Sallie Mae had the highest profit (about 0.95 percent after taxes) and Chase Manhattan had the lowest (0.18 percent). During that year, three of the nine agencies (California, Pennsylvania, and Virginia) had negative net rates of return (losses of 3.31, 0.40, and 0.18 percent, respectively).

For-Profit Secondary Market Lenders Were Consistently Profitable

Sallie Mae, Chase Manhattan, and Wachovia were consistently profitable over the 4-year period, with Sallie Mae's rates of return being the highest and Chase Manhattan's the lowest. (See fig. 8.) According to officials at Chase, profits on the bank's Stafford loan portfolio were lower because of additional investments made in equipment and staff in anticipation of substantial increases in the size of its student loan operation. Stafford loans made up relatively small portions of the two commercial banks' assets—about 0.88 percent at Chase Manhattan and about 1.48 percent at Wachovia as of the end of fiscal year 1988. In contrast, student loans were a major portion of total assets for Sallie Mae and most of the state agencies.

23

Figure 8: For-Profit Institutions Were Consistently Profitable (Fiscal Years 1985-88)



State Not-for-Profit Institutions' Net Returns Varied

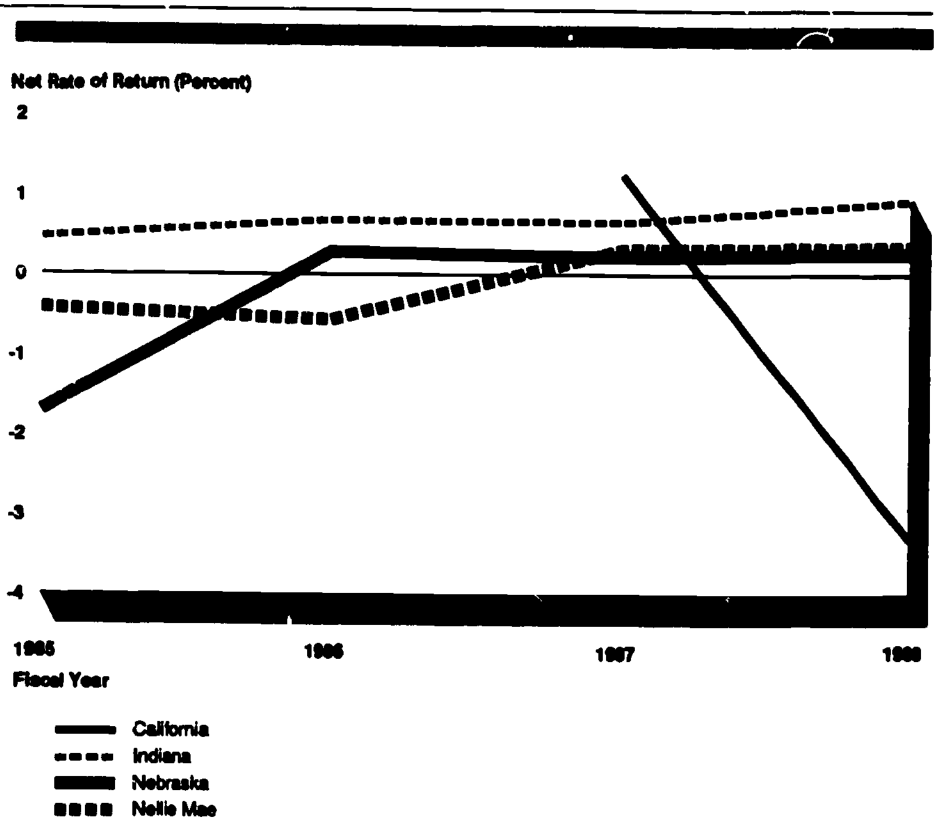
While Sallie Mae and the banks consistently earned a profit during the 4-year period, the four not-for-profit agencies' net rates of return varied considerably. Although all four had positive returns in 1987, two had losses in earlier years (Nebraska in 1985 and Nellie Mae in 1985 and 1986), and California had a large loss in 1988. (See fig. 9.) According to agency officials:

- The Nebraska agency's 1.71-percent loss in fiscal year 1985 resulted in part from high interest costs for long-term fixed interest rate securities that the agency had issued in prior years when interest rates were higher. Nebraska lowered its cost of funds considerably, from 10.63 percent in fiscal year 1985 to 7.73 percent in fiscal year 1986, by issuing lower yield securities to replace earlier higher yield securities, thereby improving its net rate of return in subsequent years.
- Nellie Mae's losses in fiscal years 1985 and 1986 of 0.43 and 0.57 percent, respectively, resulted in part because it did not receive special allowance subsidy payments for some of its loans during these years.

These loans were purchased with funds Nellie Mae raised by issuing tax-exempt securities before it obtained approval of its plan for using such funds to finance Stafford loans. The loans were therefore ineligible for special allowance payments until Nellie Mae received state approval.

- The California agency incurred a 3.31-percent loss in calendar year 1988 largely because it included in its costs a provision for future losses on delinquent loans of 3.34 percent. The agency may incur significant one-time losses if the Department of Education or the guaranty agency determines that certain delinquent loans were not appropriately serviced and therefore refuses to pay default claims.

Figure 9: Not-for-Profit Agencies' Returns Varied (Fiscal Years 1985-88)



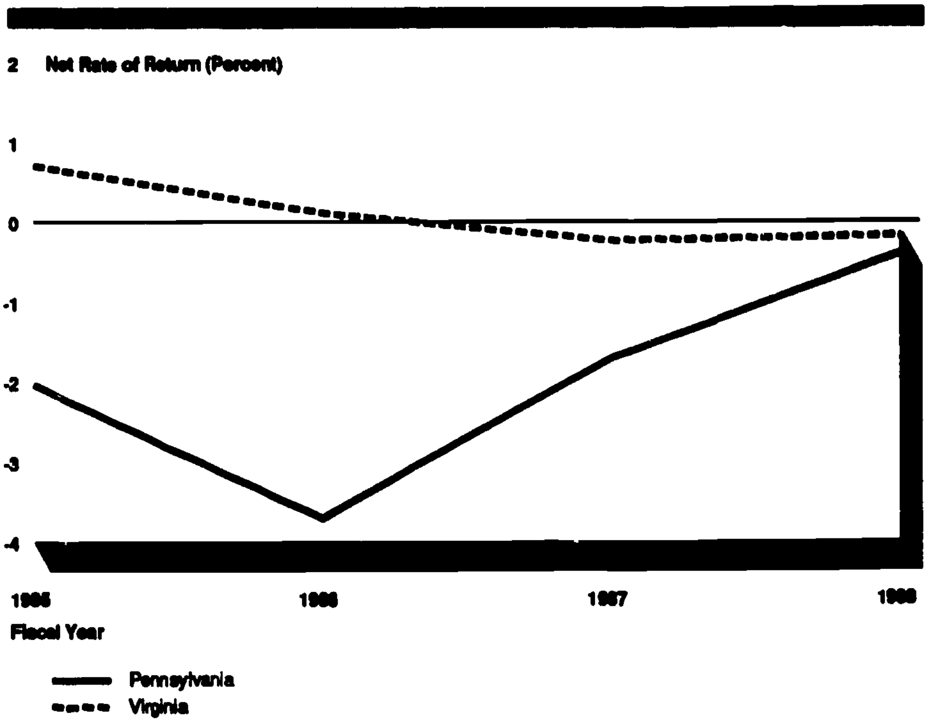
Note. California agency data not available for fiscal years 1985 and 1986

State Governmental Agencies Have Had Losses

The Virginia agency earned a profit in fiscal years 1985 and 1986, but incurred losses in 1987 and 1988. The Pennsylvania agency had losses in all four years. (See fig. 10.) The Colorado agency did not provide sufficient revenue data to determine its profitability during the 4-year period.

Virginia's losses were attributed to its high cost of funds—the highest reported of the 10 institutions in 1986, 1987, and 1988. A Virginia agency official explained that the agency had issued fixed rate tax-exempt bonds at a time when interest rates were higher. The Pennsylvania agency, as was the case with Nellie Mae, lost potential revenue because it was initially not eligible to receive special allowance payments. It began to receive the subsidy payments in January 1987, after its plan for the use of tax-exempt financing was approved.

Figure 10: State Governmental Agencies' Returns Varied, but Each Has Had Losses (Fiscal Years 1985-88)

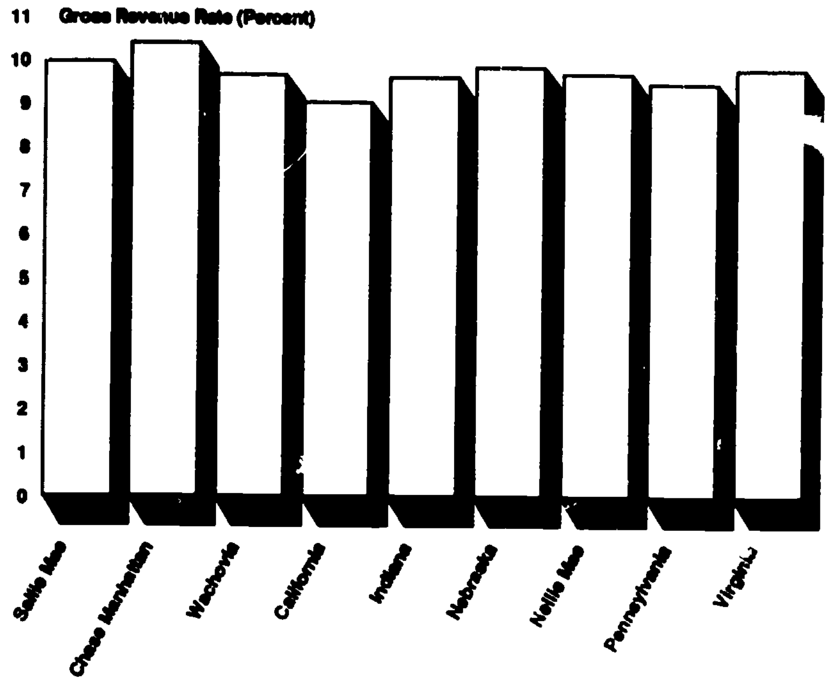


Revenues Were Similar

As shown in figure 11, the secondary market institutions' gross revenues as a percentage of outstanding loans varied in 1988 within a

1.35-percentage-point range—from 9.03 to 10.38 percent of their Stafford loan portfolios.[6]

Figure 11: Institutions' 1988 Gross Revenues Were Similar



Note Colorado agency data not available

Although the special allowance payment for tax-exempt financed loans is generally one-half of that for taxable-financed loans, loans financed with tax-exempt funds are guaranteed a gross interest revenue rate of at least 9.5 percent.[7] When the Treasury bill rates to which subsidies are tied are relatively low—as was the case in recent years—the revenue rates on tax-exempt financed loans can approach, or even exceed, those on taxable financed loans. Figure 12 illustrates the effect of the 9.5-percent floor on lenders' gross interest revenues for their tax-exempt funded loans during fiscal years 1985-88. The floor raised agencies'

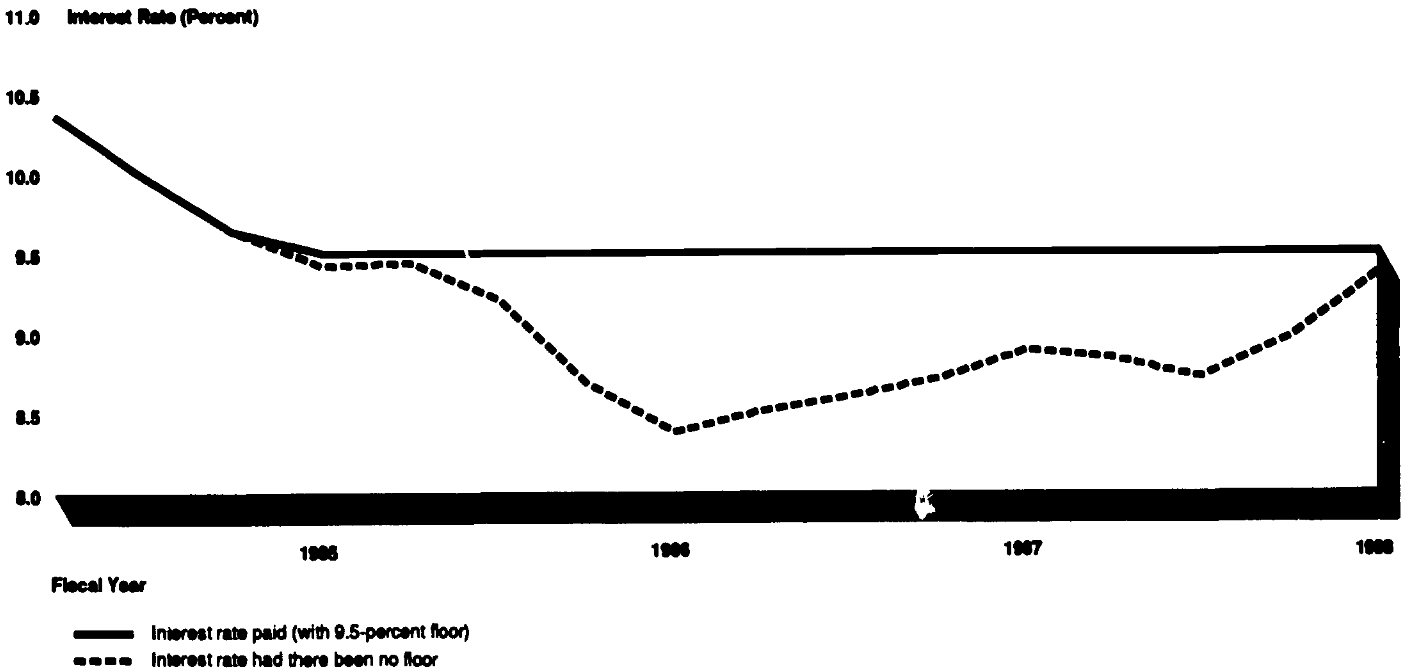
[6]Some of the variations in revenues resulted from the use of different reporting periods Two agencies used the year ended December 31, and the others used September 30, 1988 Average Treasury bill rates in the quarter ending December 31, 1988, rose above earlier levels, thereby increasing annual interest subsidy revenues for the two agencies.

[7]Stafford loans made or purchased with tax-exempt funds before the beginning of fiscal year 1981 earn special allowance payments at the same rate as loans made or purchased with taxable funds

27

revenues on tax-exempt financed loans in periods of relatively low Treasury bill rates.

Figure 12: 9.5-Percent Interest Revenue Floor Increased Returns on Tax-Exempt Financed Loans (Fiscal Years 1985-88)



Quarterly revenues of lenders who used tax-exempt financing were as much as 1.12 percent higher than they would have been without the interest rate floor in 13 of the 16 quarters during the 4-year period. For example, we estimate that in fiscal year 1988 the seven state agencies we reviewed received about $8 million more than they would have without a 9.5-percent interest revenue floor. For all agencies that use tax-exempt financing, we estimate that the provision increased revenues by about $19 million in that year. However, the institutions that benefited from the subsidy reduction exemptions included the least profitable of the 10 we studied. Furthermore, in 7 of the 16 quarters, Treasury bill rates declined to the point that the 9.5-percent interest revenue floor provided the state agencies higher interest revenue for tax-exempt financed loans than for taxable financed loans, which have no minimum special allowance payment.

Federal Cost Reduction Initiatives Have Had Little Effect on Lenders' Revenues to Date

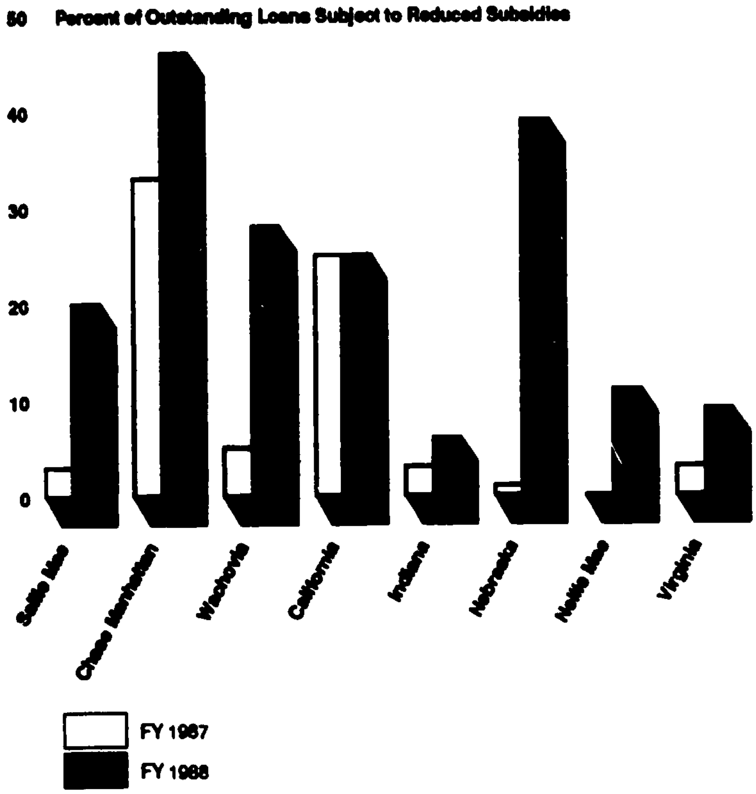
Two congressional changes were enacted in 1986 to reduce federal interest subsidy costs that resulted in slightly lower revenues for most lenders. The first was temporary; the second remains in effect:

- The Gramm-Rudman-Hollings sequester reduced the interest subsidy rate factor used to calculate special allowance payments by 0.4 percent for loans made between March 1 and September 30, 1986. This reduction remained in effect for four quarterly payments on each affected loan.
- The Higher Education Amendments of 1986 reduced the interest subsidy rate factor for taxable financed loans made after November 15, 1986, by 0.25 percent, from 3.5 to 3.25 percent. This provision applies for the life of these loans.

Although the Gramm-Rudman-Hollings reduction applied to all Stafford loans, in practice it did not affect tax-exempt financed loans. The 91-day Treasury bill rates were low enough that these loans earned the minimum 9.5-percent return provided for by law. In contrast, institutions that held taxable financed loans experienced reductions in revenue due to the sequester. Because of the short duration of the cut (it applied only to loans made during a 7-month period), as of September 30, 1986, this temporary subsidy rate reduction affected no more than 5.1 percent of any of the 10 agencies' portfolios.

The Higher Education Amendments excluded tax-exempt financed loans from the 0.25-percent reduction in the subsidy rate factor. Because many of the loans held by five state agencies, and all of the loans held by two agencies, were made or purchased with tax-exempt rather than taxable financing, the rate reduction had little, if any, effect on their gross revenues. Moreover, because the reduction applies only to loans made after November 15, 1986, many of the taxable financed loans in their portfolios were unaffected as of the end of fiscal year 1988. As a result, none of the 10 agencies' revenues decreased by the full 0.25 percent as of September 30, 1988. Revenue reductions due to the revised 3.25-percent subsidy rate factor ranged from zero for the Colorado and Pennsylvania agencies, which held only tax-exempt financed loans, to slightly more than 0.1 percent of the loan portfolio balance for Chase Manhattan Bank, which had almost half of its loans subject to the 3.25-percent rate factor. (See fig. 13.) Although Chase Manhattan's 0.1-percent revenue reduction is not as significant as the variations in its costs, it is significant when compared to its 1988 net rate of return before taxes of 0.29 percent.

Figure 13: Loans Subject to Reduced Subsidies Increased (Fiscal Years 1987-88)



Note. The Colorado and Pennsylvania agencies held only tax-exempt financed loans, which are not subject to the subsidy reduction

As the number of taxable financed loans subject to the reduced subsidy rate increases, the new rate will have a greater effect on lenders' revenues. The rate cut, however, will continue to have no impact on lenders' Stafford loan portfolios financed with tax-exempt funds.

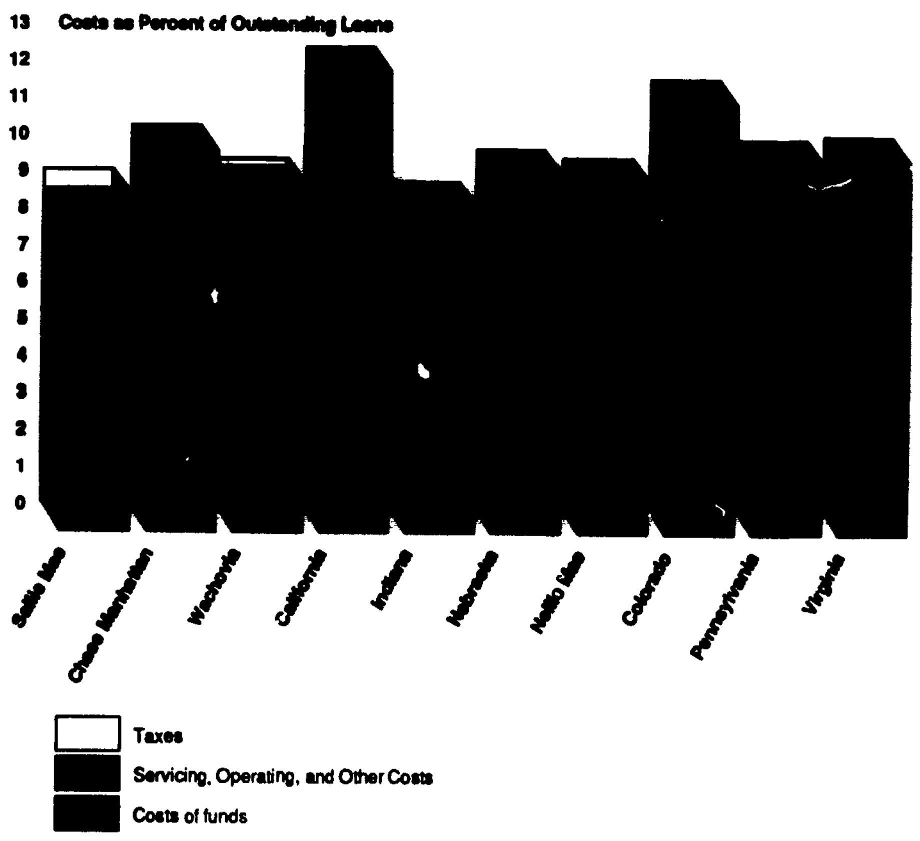
Costs Varied

As shown in figure 14, the 10 institutions' 1988 costs (cost of funds; servicing, operating, and other costs; and applicable taxes) as a percentage of their outstanding loans varied from 8.48 percent for Sallie Mae to 12.34 percent for the California agency, a range of 3.86 percentage points. While the cost of funds was the 10 lenders' largest cost element, it varied less as a percentage of outstanding loans than servicing costs or operating and other costs.

30

The cost of funds varied from 7.06 percent of outstanding loans for Sallie Mae to 8.40 percent for the Virginia agency—a range of 1.34 percentage points. In contrast, servicing costs varied by 2.13 percentage points, ranging from 0.80 percent for Sallie Mae to 2.93 percent for the Colorado agency. Operating and other costs varied by 3.89 percentage points, ranging from 0.15 percent for Wachovia to 4.04 percent for the California agency.

Figure 14: Costs Varied Among 10 Lenders (1988)



Funding Cost Variations

Many factors influence the secondary market lenders' cost of funds, including (1) the tax status of the securities issued, such as taxable or tax exempt; (2) the timing and terms of the debt issue—including the interest rate in effect at the time of issue, whether the rate is variable or fixed, and the length of the repayment period; and (3) the costs of

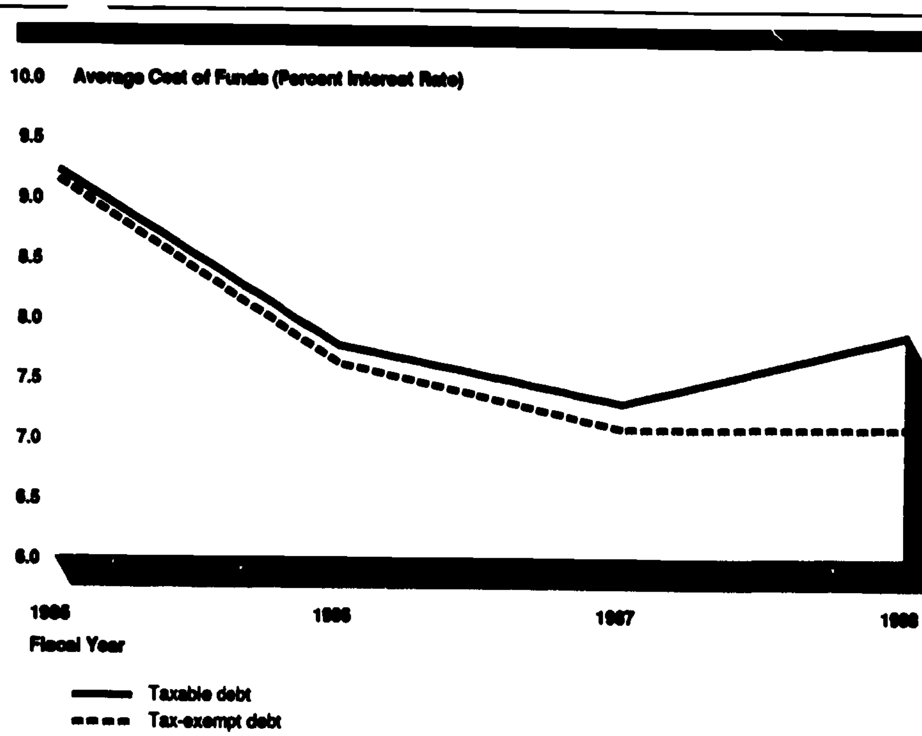
31

issuing the debt and obtaining credit enhancements, such as letters of credit. The interplay among these factors and the volatility of interest rates make it difficult to analyze and isolate the reasons for funding cost differences.

For example, while market interest rates on tax-exempt financing are generally lower than on taxable financing, a secondary market agency may incur higher average interest costs for its tax-exempt financed debt than for its taxable debt. This could occur as market interest rates declined, if it had issued long-maturity, fixed-rate, tax-exempt debt at high market interest rates, while its taxable debt was shorter-maturity and/or floating-rate. The Colorado and Pennsylvania agencies (which relied exclusively on tax-exempt financing during the period) and the Virginia agency (which used tax-exempt financing for almost two-thirds of its loan portfolio) were among those with the highest costs of funds in 1988.

In addition, for four of the five state agencies that had both taxable and tax-exempt debt, the average cost of tax-exempt debt exceeded their average cost of taxable debt in at least 1 of the 4 years for which we collected data. One of the agencies had a higher average cost for its tax-exempt debt in all 3 years that it held Stafford loans financed with both taxable and tax-exempt debt. However, while the cost of tax-exempt debt exceeded that of taxable debt for some institutions in some years, overall the average cost of outstanding taxable debt exceeded the average cost of tax-exempt debt outstanding in all 4 years. (See fig. 15.)

Figure 15: Tax-Exempt and Taxable Financing Costs Were Similar (Fiscal Years 1985-88)

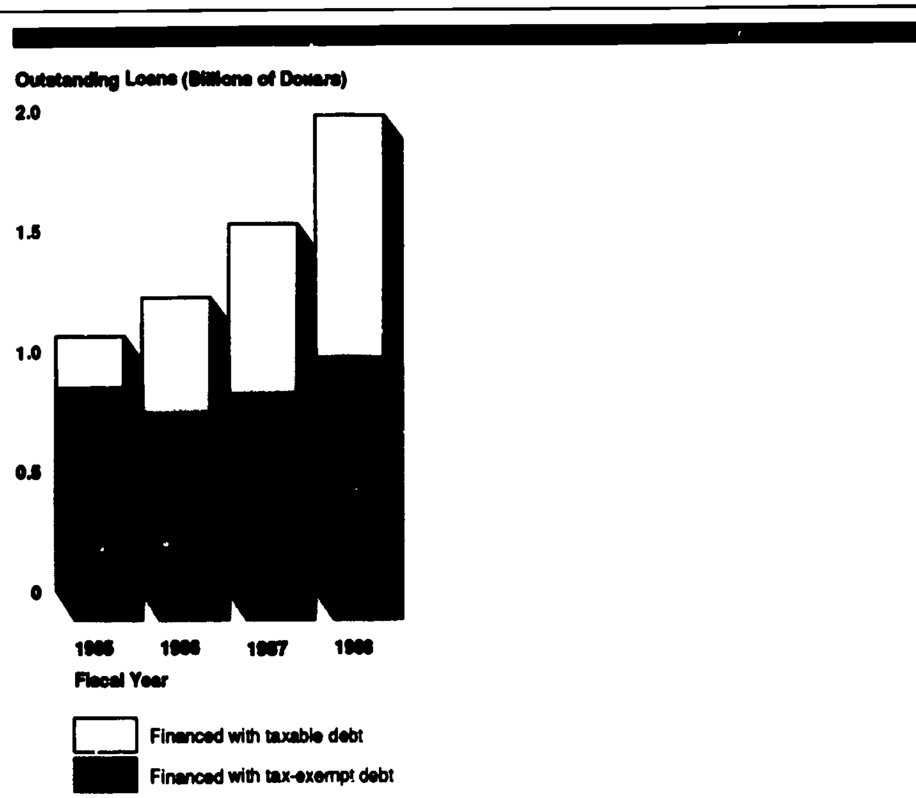


However, the 1986 Tax Reform Act (P.L. 99-514) reduced the interest rate advantage of new tax-exempt borrowing and the availability of tax-exempt funds. The act amended the Internal Revenue Code to (1) reduce personal and corporate income tax rates, thereby lessening the tax advantage of investments yielding untaxed interest income, and (2) subject tax-exempt student loan bonds to an alternative minimum tax that requires certain investors to pay income tax on their interest, notwithstanding the tax-exempt status of the bonds. For new taxable and tax-exempt debt, these changes tend to narrow the difference between interest rates.

The 1986 Tax Reform Act also reduced the availability of tax-exempt funds by restricting, in stages, the amount of tax-exempt debt a state could issue each year. For calendar year 1988, this volume cap limit was $50 per capita, or $150 million for each state—whichever was greater. For the six state agencies that provided data for all 4 years, the proportion of Stafford loan portfolios financed with tax-exempt borrowings declined from over 75 percent of outstanding loans at the end of fiscal year 1985 to less than 50 percent at the end of fiscal year 1988, although the dollar volume of tax-exempt loans rose over the period.

(See fig. 16.) For example, an official at the Virginia agency told us it was unable to issue additional tax-exempt debt to purchase Stafford loans in 1987 and 1988 because the agency did not receive state approval for an allocation under the state's volume cap for new tax-exempt bond issues.

Figure 16: Proportion of Loans Financed With Tax-Exempt Funds Has Declined
(Fiscal Years 1985-88)

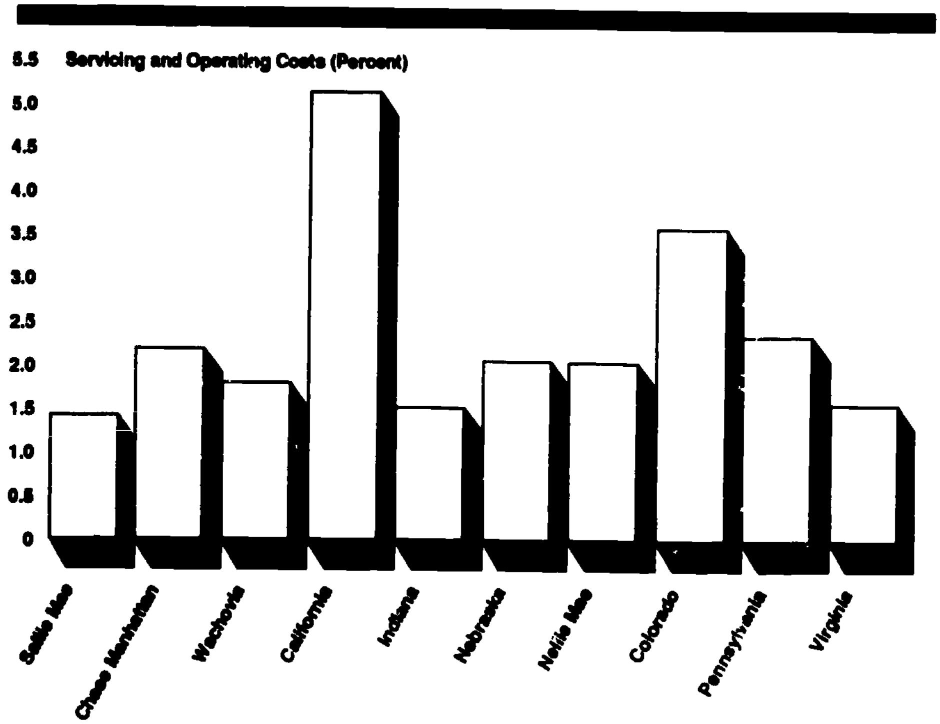


Servicing and Other Costs Varied

Nonfund costs, which include the cost of servicing and all other Stafford loan-related costs other than the cost of funds, varied somewhat among the 10 institutions in fiscal year 1988 (see fig. 17). Sallie Mae, with the largest portfolio, had the lowest nonfund costs that year (1.42 percent of outstanding loans). However, there was no apparent connection between the size of the other institutions' portfolios and their nonfund costs. Rather, differences in lenders' servicing and operating costs reflect their operating policies and experiences. Among circumstances officials described to us to explain their nonfund costs were the following:

- Though the California agency reported relatively low servicing and operating costs, its fiscal year 1988 total nonfund costs exceeded the other nine institutions' costs, reflecting a 3.34-percent provision for losses on delinquent loans. According to an agency official, some defaulted loans may not be reimbursed by the guaranty agency or the Department of Education if either determines that they were not properly serviced.
- The Colorado agency's high fiscal year 1988 nonfund costs (3.58 percent of outstanding loans), according to an agency official, reflected expenses related to its transition from in-house to contracted servicing.
- The Pennsylvania agency reported high nonfund costs in all 4 years. The agency services loans for other lenders in addition to its own, and it used the proceeds from its loan-servicing operation to help subsidize loans to borrowers who do not qualify for federal subsidies under Stafford loans.
- According to a bank official, Chase Manhattan's relatively high nonfund costs (2.19 percent in fiscal year 1988) increased from previous years, in part due to additions to its staff and equipment in anticipation of expanding its student loan activities.

Figure 17: Servicing, Operating, and Other Costs Varied in Fiscal Year 1988

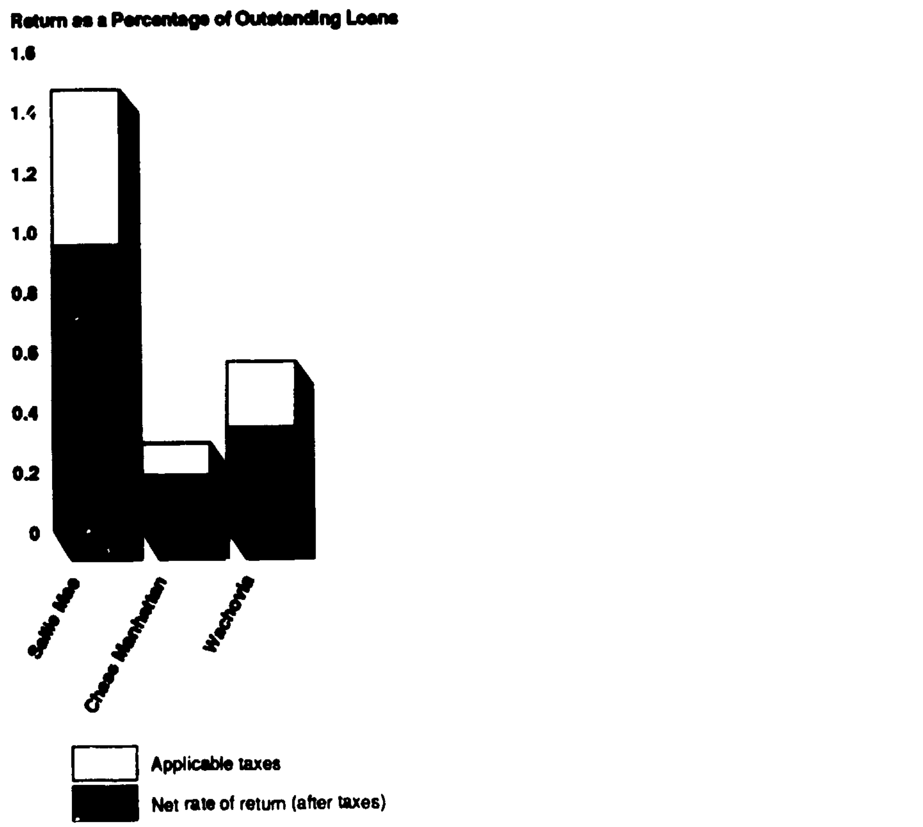


35

Taxes Substantially Reduced For-Profit Lenders' Returns

Unlike the seven state agencies, Sallie Mae and the two banks are subject to income taxes. Sallie Mae pays federal corporate income taxes, but is exempt from state and local income taxes. The banks are subject to both federal and state taxes. As shown in figure 18, the payment of taxes substantially reduced these three lenders' net rates of return on Stafford student loans in fiscal year 1988.

Figure 18: Taxes Reduced Federal and Commercial Lenders' Profitability in Fiscal Year 1988



Conclusions

Profits from Stafford loans varied considerably during fiscal years 1985-88 among the secondary market institutions that we reviewed. The variations resulted more often from variations in costs than from variations in revenue.

In addition, the 1986 subsidy reductions had little or no effect on lenders' revenues. For some lenders in some years, however, the reductions could be significant when compared to profits because profit margins were relatively narrow.

Four of these institutions consistently earned a profit on their Stafford loans, including the two commercial lenders and Sallie Mae, all of which are for-profit entities. The other lenders incurred losses in 1 or more years. These lenders were not-for-profit or state agencies that entered the secondary market for reasons other than making a profit.

The variations in profit levels, and the many reasons for them, indicate that profitability measures do not, in themselves, provide a sound basis for determining the appropriate special allowance factor.

Agency Comments and Our Evaluation

The Department of Education and 9 of the 10 lending institutions we reviewed commented on a draft of this report. The Department had only a technical comment that we addressed in appendix II. Our evaluation of the comments received from the institutions are summarized below.

1. Several institutions suggested we more clearly emphasize that the 10 participants in the study may have used different assumptions or methods to allocate costs, and that 2 of the participants provided data on a calendar year rather than a fiscal year basis.

While we requested comparable data from all institutions and identified possible inconsistent assumptions or allocations of costs, we recognize that differences among the lenders exist. We discuss data limitations in appendix I.

2. Several lenders stated that their costs have increased since the completion of our review. According to these lenders, increases included higher letter-of-credit costs and higher administrative costs attributed to stricter enforcement of due diligence requirements. Lenders also stated that their revenues had been adversely affected by (1) Treasury Department regulations that reduced the benefits of using tax-exempt financing and (2) lower special allowance payments, which are having a greater impact on revenues each year.

We recognize that profit levels of some institutions may have changed since our review. We state in the report that the impact of the reduction in the special allowance rate should be greater for some agencies in future years. Our analysis was limited to the 1985-88 period, and we did not attempt to forecast any future changes in lenders' operations. However, where appropriate, we have incorporated the lenders' concerns in the report.

3. Our original draft of this report contained a consultant's paper that discussed the legal and institutional factors affecting the secondary market in guaranteed student loans. In their comments on the report, some institutions suggested that the information from the paper was valuable, while others disagreed with some of the information the paper contained.

While we believe the paper provided a useful description of the characteristics of the secondary market for student loans, we have deleted it from our report because of the controversy it generated among the institutions and our concern that it would divert attention away from the major focus of the report.

4. The two commercial banks were concerned about public disclosure of the information they provided.

We discussed the issue with officials of the two banks and agreed to (1) treat the detailed information that they provided, and which was not included in our draft report, as proprietary, and (2) identify in our report the institutions' revenue, costs, and profitability analyses which were included in our draft report.

5. Several lenders suggested revisions and technical changes to increase the accuracy or clarity of the report. We made changes where appropriate.

Methodology

Early in our review, we held a conference with participants and other knowledgeable parties in the student loan community, such as representatives from the Department of Education, the Congressional Budget Office, and secondary markets, to help us develop our study approach. We also contracted with an expert on government-sponsored enterprises to identify and describe the legal and institutional benefits, limitations, and other factors that influence the efficiency, competitiveness, and profitability of the three major kinds of secondary market institutions.

As agreed in discussions with congressional staff, we focused our efforts on a group of major secondary markets, that is, financial institutions that purchase Stafford loans from originating lenders, such as banks, savings and loan associations, and credit unions. Because many secondary markets deal primarily in student loans, we expected that they would be more likely than originating lenders to maintain financial data that could be used to determine the profitability of their Stafford loan portfolios.

We focused our analysis on the student loan holdings of 10 major secondary markets during fiscal years 1985-88. These 10 accounted for about one-third of all Stafford loan holdings at the end of fiscal year 1988 and nearly three-fourths of all Stafford loan purchases lenders reported to the Department of Education for fiscal year 1988.

The 10 institutions were judgmentally selected to represent the three basic kinds of entities: commercial banks, state agencies, and an institution chartered by the federal government to provide a secondary market for student loans. As a basis for our sample selection, we used Department of Education data on dollar volume of Stafford loan holdings and purchases by secondary market institutions. Of the institutions selected—other than Sallie Mae, the dominant secondary market entity—two were commercial banks. To provide a cross-section of the different kinds of state agencies, we selected four not-for-profit corporations and three state governmental agencies. Six of the 10—the two banks, the three state governmental agencies, and one of the state not-for-profit institutions—originate as well as purchase loans. All 10 were among the top 40 holders of guaranteed student loans in fiscal year 1988.

We sent questionnaires to each of the 10 institutions requesting data for fiscal years 1985-88 regarding special allowance payments, revenues, and cost of funds and servicing, operating, and other costs not related to financing.

39

Data Collection

We mailed each of the 10 institutions three questionnaires:

- Special allowance payment questionnaire—requested, by year, a breakdown of loan portfolio by the SAP factor (3.5 percent, 3.25 percent, or other) used to calculate special allowance payments.
- Cost of funds questionnaire—requested distribution of fiscal year-end loan balances by source of funding (taxable, tax-exempt, or other) and the cost of funds for and rate of return on student loans. Additional items on this questionnaire included letters of credit and their cost purchase price of portfolios (whether at par or at a premium or discount), and whether new borrowings were at fixed or floating interest rates.
- Servicing and operating cost questionnaire—requested loan-servicing costs, operating costs, and other costs not related to the cost of funds; proportions of portfolio serviced by the institution or contracted out; and comments, including a description of efforts to constrain these costs.

We requested cost and revenue data as a percentage of portfolio rather than in terms of dollar volume. In those cases where we determined from talking to responsible officials that they had based their cost and/or revenue percentages on some other measure of portfolio, we asked them to recalculate using average daily loan balance.

We tabulated data received in response to these questionnaires and used the data to calculate rates of profitability and to assess the relative importance of various factors to explain variations in profitability. Though we use the terms "profitability," "profit," and "loss" in discussing net returns of all these institutions, we recognize that state agencies' activities do not generate profits as such.

To calculate net rates of return, or "profits," we aggregated the cost of funds, servicing, operating, and other costs (all as percentages of loan balances) and then deducted the sum of these costs from interest revenue (made up of borrowers' interest plus federal special allowance payments). Where applicable—that is, for the two banks and Sallie Mae—we deducted taxes to obtain their net rate of return after taxes.

Data Validation

We checked data validity principally by examining the internal consistency of data provided; the consistency of those data within the context of relevant laws and regulations; and, to a limited extent, the consistency of questionnaire data with data reported to the Department of Education, such as institutions' annual reports and financial statements. For example, we checked the volume of an institution's loans subject to the reduced special allowance payment against outstanding loans funded with taxable loans. Because the reduction did not apply to loans from tax-exempt funds, any excess of 3.25-percent special allowance payment loans over taxable funded loans suggested an error in one of the totals. We also calculated a range of possible rates of return (interest revenue) based on formulas specified by law and compared these ranges with rates of return the institutions reported.

We interviewed Department of Education officials and financial officials at the secondary market institutions to confirm our interpretations of the regulations. We reviewed reports by the Department, the Congressional Budget Office, and the Congressional Research Service, as well as other literature relating to student loan finance.

When we had obtained corrected data or explanations of apparent inconsistencies, we sent review copies of our compiled and derivative data to financial or executive officers at each of the 10 institutions, requesting that they make any needed changes.

Nine of the 10 institutions sent confirmation of the data. Some of these included additional revisions. California sent us additional financial data on which to base the requested data but asked us to perform the calculations. To do so, we allocated operating costs and the cost of funds between taxable and tax-exempt funds in the same proportion that the agency allocated outstanding debt.

We conducted our work between January 1988 and February 1990 in accordance with generally accepted government auditing standards.

Data Limitations

Notwithstanding our extensive efforts to reconcile data inconsistencies, certain data limitations remain.

Data Validity

Except where our data analysis revealed inconsistencies, we did not attempt to verify or validate the data institutions provided us.

41

Imprecision Due to Use of Estimates

Some data represent estimates rather than exact values. For example, Virginia's agency cautioned that some of its data are estimates and that because of the use of average balances, its data should not be construed as exact. As another example, the California data are estimates based on that agency's guaranteed student loan portfolio; the agency does not maintain separate cost data on its Stafford loan holdings.

Fiscal Year Variations

We requested data for fiscal years ending September 30. However, only 2 of the 10 entities operate on the federal fiscal year. Of the eight that operate on other fiscal years, all but two provided cost and revenue estimates based on the federal fiscal year.

Of the two entities that did not provide data based on the federal fiscal year, one pointed out that because of year-end adjustments, conversion to a September 30 fiscal year would result in distorted data. As noted on affected figures, those two institutions' data are by calendar year. They are therefore not directly comparable to the other institutions' data, particularly when interest rates for the calendar year differ substantially from rates for the fiscal year.

Moreover, we do not know how the institutions that converted their data for us handled year-end adjustments in completing our questionnaires. One of the six that converted their data commented that the conversion probably entailed some sacrifice of precision.

Trend Data

To present a cross-section of the agencies represented, summary data and charts representing trends in cost of taxable and tax-exempt funds over time were developed using simple averages of the agencies' costs. Because they are not weighted by loan volume, they do not reflect the aggregate costs of the 10 institutions' portfolios financed with taxable funds as compared with those financed with tax-exempt funds.

Further, because we included institutions' data as available, averages do not represent the same number of institutions in each year. One agency was unable to separate guaranteed Stafford loan costs from costs of other student loan programs and was unable to provide cost of funds data for 2 of the 4 years. Another was unable to separate out guaranteed Stafford loan revenue for any of the years.

Differences in Operations

Because of variations in the 10 institutions' operations, costs do not always reflect the same cost elements. In figure 14, for example, servicing costs may reflect in-house servicing, contracted servicing, or a mix of the two.

Differences in Accounting Practices

In addition to differing in their operations, lenders differed in their methods of accounting for costs. For example, we asked institutions to include in their cost of funds all costs incident to obtaining funds. Debt issuance costs institutions told us they had included in the cost of funds varied somewhat, and we did not attempt to eliminate those variations. Nor did we attempt to adjust institutions' cost of funds for variations in their accounting practices with respect to some cost elements—premiums paid on loan purchases, for example.

We recognize that, since the completion of our review, the financial condition of the institutions could have changed. For example, since 1988 the institutions' borrowing costs have likely increased. Also, costs may have increased due to stricter loan servicing requirements imposed by the Department.

Data Supporting Figures

Table II.1: Ten Institutions' Loan Holdings Doubled (Fiscal Years 1985-88) (Data for Fig. 6)

Dollars in billions

	Outstanding amount of Stafford loans			
Fiscal year	**Sallie Mae**	**Two banks**	**Seven state institutions**	**Total**
1985	$5.144	$0.871	$1.423	**$7.438**
1986	6.271	0.854	1.753	**8.878**
1987	7.419	1.095	2.449	**10.963**
1988	9.357	1.068	3.054	**13.479**

Note: This table does not include a major portion of Pennsylvania's guaranteed student loans. We excluded loans to students not eligible for federal interest subsidies (about $8.2 million, $22 1 million, $71 5 million, and $340.2 million at the end of fiscal years 1985-88, respectively). According to an agency official, these loans were made to students who were ineligible for federal interest subsidies because, for example, their incomes exceeded federal limits. Nonetheless, according to this official, their loans are guaranteed just as other Stafford loans by federally supported guaranty agencies. We also excluded from our analysis about $7 1 million of loans eligible for federal interest subsidies that Pennsylvania purchased with taxable funds the last day of fiscal year 1988 because the agency did not provide data for these loans

Table II.2: Nine Institutions' Profitability Varied Widely (Fiscal Year 1988) (Data for Fig. 7)

Lender[a]	**Net rate of return in 1988 as a percent of portfolio**[b]
Sallie Mae	0.95
Chase[c]	0.18
Wachovia	0.34
California[c]	−3.31
Indiana	0 92
Nebraska	0 26
Nellie Mae	0.34
Pennsylvania	−0.40
Virginia	−0 18

[a]Insufficient data were available to calculate Colorado's rate of return

[b]Net rates of return were calculated after taxes, if applicable

[c]California and Chase data are for calendar year 1988, other data are for the fiscal year ending September 30, 1988

44

Table II.3: For-Profit Institutions Were Consistently Profitable (Fiscal Years 1985-88) (Data for Fig 8)

	Net rate of return as a percent of portfolio					
	After taxes			Before taxes		
Year[a]	Sallie Mae[b]	Wachovia[c]	Chase[d]	Sallie Mae	Wachovia	Chase
1985	0 96	0.64	0 29	1.78	1.26	0.57
1986	0.83	0.46	0 29	1 53	0.90	0 57
1987	0.88	0.42	0 23	1.50	0.77	0.43
1988	0.95	0.34	0 18	1.47	0.56	0.29

[a]Chase data are for calendar years; other data are for fiscal years ending September 30

[b]Unlike the other institutions reviewed, Sallie Mae included in its figures adjustments for expected increases in servicing costs as loans mature These adjustments were 0.22, 0.18, 0 11, and 0 14 percent in fiscal years 1985-88, respectively. These adjustments were treated as deferred income in Sallie Mae's financial reports and as additions to costs in the figures Sallie Mae provided to GAO The figures provided by Sallie Mae indicate that taxes as a percentage of net income were about 46, 46, 41, and 35 percent in fiscal years 1985-88, respectively Due to such items as tax-exempt income and tax benefits in lease transactions, Sallie Mae's effective tax rates (taxes as a percentage of net income from all sources) for all operations were 38 9, 35.0, 31 0, and 27 4 percent in calendar years 1985-88, respectively Unlike the banks, Sallie Mae is exempt from state and local taxes

[c]Wachovia's student loan operations were subject to state as well as federal income tax Wachovia reported that its taxes as a percentage of net income were about 49, 49, 45, and 40 percent in fiscal years 1985-88, respectively Due to income from tax-exempt securities, investment tax credits, etc , Wachovia's effective tax rates for all operations were lower—for example, about 22 percent in calendar year 1988

[d]Chase was subject to federal and state corporate income tax The data Chase provided indicate that taxes as a percentage of net income were about 49, 49, 47, and 38 percent in fiscal years 1985-88, respectively Due to losses from other operations (income from tax-exempt investments, etc), Chase's effective tax rate (total provision for taxes as a percentage of net income before taxes) was lower—for example about 20 percent in calendar year 1988

Table II.4: Not-for-Profit Agencies' Returns Varied (1988) (Data for Fig 9)

	Rate of return as a percent of portfolio			
Year[a]	California[b]	Indiana	Nebraska	Nellie Mae
1985	c	0.46	−1 71	−0 43
1986	c	0.68	0 28	−0 57
1987	1 24	0.65	0 22	0 31
1988	−3 31	0 92	0 26	0 34

[a]California data are for calendar years 1987 and 1988 The other agencies provided data for fiscal years ending September 30

[b]California's agency did not provide sufficient data to calculate net rates of return in fiscal years 1985 and 1986

[c]Not available

45

Table II.5: State Governmental Agencies' Returns Varied, but Each Has Had Losses (Fiscal Years 1985-88) (Data for Fig. 10)

	Rate of return as a percent of portfolio	
Fiscal year	**Pennsylvania**	**Virginia**
1985	−2.04	0.70
1986	−3.71	0.11
1987	−1.71	−0.24
1988	−0.40	−0.18

Note Colorado's agency provided insufficient data to calculate profits

Table II.6: Institutions' 1988 Gross Revenues Were Similar (Data for Fig 11)

Lender	**Revenue as a percent of portfolio[a]**
Sallie Mae	9.95
Chase[b]	10.[illegible]
Wachovia	9.66
California[b]	9.03
Indiana	9.60
Nebraska	9.83
Nellie Mae	9.69
Pennsylvania	9.47
Virginia	9.79

[a]Chase and California data are for calendar year 1988, other data are for the fiscal year ending September 30, 1988

[b]Chase's revenue was highest, at least in part, according to a bank official, because its data were for calendar year, not fiscal year, 1988 and interest rates were higher in the fourth quarter of calendar year 1988 (the quarter following the end of fiscal year 1988) California also reported revenue for the calendar year, but its revenue was nevertheless the lowest, at least in part, according to the agency's treasurer, because it did not receive interest subsidies for many of its loans as a result of servicing problems Except for Chase, Sallie Mae had the highest revenue (9.95 percent) and California had the lowest (9.03) Thus, revenue varied within a 0.92-percentage-point range

Table II.7: 9.5-Percent Interest Revenue Floor Increased Returns on Tax-Exempt Financed Loans[a] (Data for Fig. 12)

	Interest rate	
Fiscal year/quarter	Interest paid with 9.5-percent floor	Interest calculated without 9.5-percent floor
1985		
1	10.36	10.36
2	9.98	9.98
3	9.64	9.64
4	9.50	9.42
1986		
1	9.50	9.44
2	9.50	9.21
3	9.50	8.69
4	9.50	8.38
1987		
1	9.50	8.51
2	9.50	8.60
3	9.50	8.71
4	9.50	8.89
1988		
1	9.50	8.84
2	9.50	8.72
3	9.50	8.97
4	9.50	9.37

[a]Total interest lenders received from borrowers and the Department of Education on loans to first-time borrowers (all 8-percent loans) financed with tax-exempt funds

47

Table II.8: Loans Subject to Reduced Subsidies Are Increasing (Fiscal Years 1987-88) (Data for Fig 13)

Percent of portfolio subject to 3.25-percent special allowance provision

Lender	End of fiscal years 1987	1988
Sallie Mae	3	20
Chase	33	46
Wachovia	5	28
California[a]	25	25
Indiana[a]	3	6
Nebraska[a]	1	39
Nellie Mae[a]	0	11
Colorado[a,b]	0	0
Pennsylvania[a,c]	0	0
Virginia[a]	3	9

[a]State agency

[b]Colorado had only tax-exempt financed loans, which were not subject to the subsidy reduction

[c]Except for taxable financed loans purchased on the last day of fiscal year 1988 that were not included in any of Pennsylvania's data, all of the agency's loans were financed from tax-exempt sources and thus were not subject to the reduction

Table II.9: Costs Varied Among 10 Lenders (Fiscal Year 1988) (Data for Fig 14)

	Costs as a percent of portfolio in 1988				
Lender	Cost of funds	Servicing costs	Operating and other costs	Lender taxes[a]	Total
Sallie Mae	7.06	0.80	0.62	0.52	**9.00**
Chase[b]	7.90	1.29	0.90	0.11	**10.20**
Wachovia	7.30	1.65	0.15	0.22	**9.32**
California[b]	7.21	1.09	4.04	0.00	**12.34**
Indiana	7.16	1.03	0.49	0.00	**8.68**
Nebraska	7.51	1.50	0.56	0.00	**9.57**
Nellie Mae	7.31	1.12	0.92	0.00	**9.35**
Colorado	7.93	2.93	0.65	0.00	**11.51**
Pennsylvania	7.52	1.68	0.67	0.00	**9.87**
Virginia	8.40	1.05	0.52	0.00	**9.97**

[a]Applicable only to Sallie Mae and the two banks

[b]Chase and California data are for calendar year 1988, other data are for the fiscal year ending September 30, 1988

48

Table II.10: Tax-Exempt and Taxable Borrowing Costs Were Similar (Fiscal Years 1985-88) (Data for Fig. 15)

Average borrowing costs (figures are in percent)

Year	Taxable	Tax exempt
1985	9 22	9 14
1986	7 77	7.62
1987	7 29	7.08
1988	7 86	7.09

Note Data shown are unweighted averages for state agencies that reported the cost of both taxable and tax-exempt debt at some time during the fiscal year 1985-88 period The averages represent different numbers of agencies in different fiscal years. three in fiscal year 1985; four in fiscal year 1986; five in 1987 and 1988. Virginia was not included in the fiscal year 1985 averages because it had no taxable financed loans in that year. California was not included in the fiscal year 1985 and 1986 averages because it did not provide data on the costs of its tax-exempt and taxable debt in those years. Colorado and Pennsylvania were not included in any of the averages because they reported no taxable financed debt during the fiscal year 1985-88 period Chase and California data are for calendar years, other data are for the fiscal year ending September 30, 1988.

Table II.11: Proportion of Loans Purchased With Tax-Exempt Funds Has Declined (Fiscal Years 1985-88) (Data for Fig. 16)

Dollars in millions

Fiscal year	Loan holdings from tax-exempt debt	Percent of total	Loan holdings from taxable debt and other sources	Percent of total	Total loans[a]
1985	$843	80	$216	20	**$1,059**
1986	736	60	482	40	**1,217[b]**
1987	815	53	710	47	**1,525[b]**
1988	967	49	1,008	51	**1,975**

Note: Data shown are totals for six state agencies that provided data for all 4 years

[a]Sum of the columns does not equal the total due to rounding

[b]Data for the end of fiscal years 1986 and 1987 include about $4 million of loans in Indiana's portfolio financed from neither tax-exempt nor taxable debt

Table II.12: Servicing and Operating Costs Varied (Fiscal Year 1988) (Data for Fig. 17)

Lender	Cost as a percent of portfolio[a]
Sallie Mae	1.42
Chase	2.19
Wachovia	1.80
California	5 13
Indiana	1 52
Nebraska	2 06
Nellie Mae	2.04
Colorado	3 58
Pennsylvania	2 35
Virginia	1 57

[a]Chase and California data are for calendar year 1988, other data are for the fiscal year ending September 30, 1988

Table II.13: Taxes Reduced Federal and Commercial Lenders' Profitability (Fiscal Year 1988) (Data for Fig 19)

	Profits as a percent of portfolio[a]		
Lender	Rate of return before taxes	Applicable taxes	Net rate of return after taxes
Sallie Mae	1 47	0 52	0 95
Chase	0 29	0.11	0.18
Wachovia	0 56	0 22	0.34

[a]Chase data are for calendar year 1988, other data are for the fiscal year ending September 30, 1988

50

Comments From the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE ASSISTANT SECRETARY FOR POSTSECONDARY EDUCATION

AUG 17 1990

Mr. Franklin Frazier
Director, Education and Employment Issues
United States General Accounting Office
Human Resources Division
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to review GAO draft report, "Guaranteed Student Loans: Secondary Market Lenders' Profits Vary Widely" GAO/HRD 90-130, dated July 19, 1990.

The Department offers the following technical comments to be taken into consideration when preparing the final report.

Now on pp 47 and 27

Table III.7, page 92 and Figure 12, page 29

Calculations for fiscal year 1987, quarters 1, 2, and 3 for interest calculated without 9.5 percent floor in effect are correct if you consider each quarter alone. However, it does not represent the true effect depicted in the report. The illustration has totally ignored the fact that most new loans made during the sequester were made during the last 3 months (July, August, and September).

If you have any questions, please contact Valerie Hurry of the Division of Quality Assurance on 708-9453.

Sincerely,

John B Childers for

Leonard L. Haynes III

400 MARYLAND AVE. S.W. WASHINGTON D.C. 20202

51

Comments From Sallie Mae

STUDENT LOAN MARKETING ASSOCIATION
1050 Thomas Jefferson Street N W
Washington, D C 20007
202-298-2600

LAWRENCE A HOUGH
President and
Chief Executive Officer

September 4, 1990

HAND DELIVERED

Mr. Franklin Frazier
Director, Education and Employment Issues
United States General Accounting Office
441 G Street, N.W., Room 6739
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to comment on the General Accounting Office's draft report "Guaranteed Student Loans: Secondary Market Lenders' Profits Vary Widely".

We endorse the Report's conclusion that the variation in profitability among the secondary markets examined is largely attributable to their respective abilities to efficiently manage the cost of servicing student loans and to effectively contain their general operating costs. In our view, the report reaches an important conclusion in its findings that the least significant variation in costs among the secondary markets studied is their cost of funds, which as is pointed out in the Report is by far the largest cost element for all secondary markets. According to the Report (Page 33), the variation as to costs of funds is "less as a percent of outstanding loans than all other cost elements (servicing, operating and other non-fund costs) combined".

Now on p 29

Material deleted, see p 37

52

Mr. Franklin Frazier
Page Two
September 4, 1990

While the Report attempts to assess the impact on lender profitability of Congressionally mandated reductions in the special allowance formula, it does not go far enough in addressing the long term impact of such reductions. Specifically, we think GAO should have attempted to isolate the effect of the 1986 Gramm-Rudman-Hollings sequestration order (which reduced the special allowance rate to T-Bill plus 3.0) on the loans actually affected by that order. This could have been accomplished by: 1) isolating that segment of each lender's loan holdings that was affected by the sequester order; 2) applying the proportional costs associated with each loan holder's portfolio to that segment; and 3) by reducing each loan holder's income on that segment of loans by the relative amount of the decrease in special allowance payments attributable to the Gramm-Rudman-Hollings sequester order. Similarly, GAO could have examined the future effects on profitability of those loans originated since November 16, 1986, the date the special allowance rate was reduced by 25 basis points under the Higher Education Amendments of 1986. Since loans subject to the reduction will eventually dominate a lender's holdings, such an analysis would have helped the Congress to better understand the full effect of long-term reductions in special allowances. Even now, because over $40 billion of GSLP loans have been made since the enactment of the 1986 Amendments, the effect on lenders' portfolios and their overall profitability is much more dramatic than would be true from an analysis which failed to look beyond fiscal 1988. This short sighted approach has seriously reduced the value of the Report.

As Sallie Mae has previously stated in correspondence and conversation with your office, we believe that GAO must acknowledge that secondary markets are not a wholly suitable proxy for the universe of guaranteed student loan lenders. While the number of secondary markets serving the GSL program have remained relatively constant over the past several years, there has been a steady decline in the number of lenders originating loans under the GSLP. This indicates that the overall health of the program and the effect of program revisions, such as reductions in the level of special allowance payments received by program participants, may not be adequately evaluated by analyses that concentrate exclusively on the secondary markets. We strongly urge that some

53

Mr. Franklin Frazier
Page Three
September 4, 1990

mention of the limitations associated with the study's concentration on secondary markets be added to the Report introduction.

Lastly, we think the Rep rt does not give adequate weight to the significant uncertainties regarding integrity of the data being reported. We suggest that the items listed in Appendix II under the heading "Data Limitations" be summarized and brought forward as part of the introduction to the Report and the accompanying summary. These limitations which include concerns regarding data validity, the use of inconsistent fiscal years, limited trend data and variations in the accounting practices of those organizations providing data to GAO, are significant enough that they should be brought directly to the reader's attention.

Material deleted, see p. 37

Sincerely,

Lawrence A. Hough

Lawrence A. Hough
President and
Chief Executive Officer

Enclosure

cc: Mr. Jay Eglin

Comments From Chase Manhattan

Chase Education Finance Center, Inc
4915 Independence Parkway, Second Floor
Tampa, Florida 33634

Stephen T Iovino

CHASE

August 20, 1990

Mr. Franklin Frazier
Director, Education and Employment Issues
United States General Accounting Office
441 G. Street Northwest
Washington, D.C. 20548

Dear Mr. Frazier:

Re: Proposed Report to Congress on Student Loan Profitability

This letter is in response to your July 19, 1990 letter to Charles Christiana.

While Chase Education Finance supports the aforementioned study, we note that the limited number of commercial bank participants weakens any conclusions that may be drawn from the study.

In Chase Education Finance's data collection package, the data were predicated on certain assumptions and estimates. Since there were no standard assumptions utilized by the participants it is probable that the variances cited with respect to gross income yields, funding and operating costs may, in part, be due to different assumptions and allocation methodologies within each institution. As a result, comparability of the results might be questionable.

Chase Education Finance has an even more basic concern. We oppose the dissemination of the study in its present form and object to any release of our confidential or proprietary information. Chase Education Finance's intention in completing the data collection forms was to provide data for consolidation with other institutions. Moreover, identification of Chase is not, in our opinion, a critical aler---- -f the study and therefore anonymity should be afforded to us.

In addition, since this study may be subject to release under the Freedom of Information Act, Chase Education Finance respectfully requests that all commercial and financial data of Chase and its participation in the study not be disclosed. It is our understanding that information which contains proprietary and confidential data is not subject to public disclosure under the Freedom of Information Act or under the GAO's regulatory policies. It is our opinion that the data provided is proprietary and confidential and should not be made available publicly.

55

Mr. Franklin Frazier
Page two
August 17, 1990

Chase Education Finance appreciates the opportunity to review the draft and communicate its position. In view of Chase's objections, I assume you will consolidate the financial data and not release Chase's data separately. If that is not the case, I am available to discuss these issues with you in greater detail. Please feel free to call me at (813) 881-8080.

Sincerely,

Stephen T. Iovino
President

STI/sah

Comments From Wachovia

Wachovia

Wachovia Bank & Trust Company, N.A.
P O Box 3099
Winston Salem, NC 27150 3099

August 15, 1990

Mr. Franklin Frazier
Director, Education and Employment Issues
United States General Accounting Office
441 G Street, N. W.
Washington, DC 20548

Re: Proposed Report to Congress on Student Loan Profitability

Dear Mr. Frazier:

This letter is in response to your July 19, 1990 letter to Kay Triplett. We appreciate the opportunity to comment on the draft report.

We support the study of lender profitability by the General Accounting Office. Although your survey was limited as far as commercial banks are concerned, your conclusions show the declining profitability of student loan assets to an after-tax margin which is not very attractive.

We cooperated in completing the "data collection instruments" citing the fact that our data input was based on certain estimates and assumptions. Some of the volatility in costs cited in your study is likely due to variances among respondents in estimating yields, funding costs and other cost allocations. We question any conclusion one might draw regarding absolute profit levels with such a small sample size. Assuming respondents used the same assumptions and estimates for each year's data, one could draw some conclusion regarding trend absent a conclusion about absolute levels.

We assume that your report may be subject to release under the Freedom of Information Act. We respectfully request that Wachovia data and Wachovia's cooperation in your study be granted anonymity.

We understand that commercial and financial information which contains privileged and confidential information is subject to exception from release under the Freedom of Information Act. We deem estimated yields, internal estimates of funding costs, and servicing and other cost estimates to be valuable proprietary information. This information is not available from other sources. Product profitability estimates may be a valuable resource internally, but should not be available for external publication. Page 8 of the draft report illustrates a plan of wide distribution absent any request under the Freedom of Information Act.

57

Mr. Franklin Frazier
Washington, DC 2 August 15, 1990

We must protest the publication of the draft report in its current form and request that GAO carefully control copies of the draft report.

Wachovia's intention in completing the data collection forms was to provide data which would be aggregated with other respondents. We do not believe that release of the identity of Wachovia Bank & Trust is necessary for the purposes of your study.

Thank you for allowing us to state our position. I would be happy to discuss our position with you and can be reached at 919-770-4554.

Sincerely,

Richard B. Roberts

Richard B. Roberts
Executive Vice President

Comments From the California Agency

CALIFORNIA STUDENT LOAN FINANCE CORPORATION

9570 W. Pico Blvd. Suite 200
Los Angeles, California 90035
213 271-1135

Sid Karsh
President &
Chief Executive Officer

August 17, 1990

Mr. Franklin Frazier
Director, Education and Employment Issues
United States General Accounting Office
Human Resources Division
Washington, D.C. 20548

Dear Mr. Frazier:

Thank you for including California Student Loan Finance Corporation (CSLFC) in the General Accounting Office's study regarding the profitability of student loans to secondary market lenders. We at CSLFC view our participation in the study as an opportunity to assist the General Accounting Office in educating Congress relative to the numerous influencing factors relating to our secondary market's profitability over the last several years.

We have reviewed the draft report you sent to us in its entirety. Clearly, it is extremely thorough and very informative. However, we could not find where inherent risk in the guaranteed student loan program is explicitly discussed. An example of this risk is where legislated change to the program retroactively changed servicing requirements for loans which were originated or purchased in previous years. When this occurred, it created an immediate profitability risk, a risk which was not a reality nor perceived to exist when the affected loans were originated or subsequently purchased. This type of retroactive change significantly altered profitability levels for lenders and holders of student loan portfolios.

Please let me know if you or your staff have any questions or comments. Again, thank you for allowing us to participate in this vitally important study.

Sincerely,

Sid Karsh

SK/th

Telecopy 213 271 5024

59

Comments From the Indiana Agency

ISM

251 North Illinois Street
Suite 1000
Indianapolis, IN 46204
317-237-2000

Indiana
Secondary
Market
for Education Loans, Inc

August 24, 1990

Mr. Joseph J. Eglin, Jr.
Assistant Director
Human Resources Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Eglin:

Thank you for the draft report entitled "Guaranteed Student Loans Secondary Market Lenders Profits Vary Widely." I have reviewed the report in detail and I believe it fairly represents information provided to the General Accounting Office by our organization. I cannot comment regarding the accuracy of the information in regard to other organizations.

It is important to note, as a matter of update, that costs of operations have increased substantially since those periods covered by the report and now represent 1.74% of outstanding student loan assets. This increase in cost of operations is largely attributable to the imposition of very prescriptive due diligence requirements of questionable value in the collection of loans. We continue to believe that greater efficiencies can be realized in costs of operations while enhancing collection effectiveness if the level of regulatory direction is tied to delinquency and default rates. Through this approach, those organizations who are ineffective in their collections would receive increased regulatory oversight and those organizations which have proven themselves capable in collection of education loans would be permitted to retain that effectiveness unfettered by prescriptive due diligence requirements.

We appreciate the opportunity to be involved in the study. Please call me if you have any questions about my comments.

Sincerely,

Stephen W. Clinton

SWC:kas

60

Comments From the Nebraska Agency

NEBHELP
Nebraska Higher Education Loan Program Inc
1300 "O" Street PO Box 82505
Lincoln, NE 68501 2505
402 475 '272
800 735 6556

August 22, 1990

Mr Franklin Frazier
Director, Education and Employment Issues
United State General Accounting Office
Washington, DC 20548

Dear Mr Frazier

Thank you for the opportunity to comment on the draft of the GAO's report on the profitability of guaranteed student loans held by secondary markets As we understand them, the objectives of the report as directed by the House Committee on Education and Labor and the Senate Committee on Labor and Human Resources were to determine

- the profitability of student loans held by major secondary markets,
- the reason for the variations in profitability. and
- the effect of the 1986 reduction in the interest subsidy rate on profitability

It would be difficult for people not directly involved in the student loan industry to comprehend the difficult nature of this undertaking, and we applaud your efforts The Nebraska Higher Education Loan Program. Inc (NEBHELP) has several concerns about the report, however, which we will address in this letter. Our concerns include the scope of the report, major changes that have occurred since the period covered in the report that make the information in the report obsolete, and the impact of the Student Loan Marketing Association's (Sallie Mae) inclusion in this report

Scope

Now on p 36

Now on pp 28-29

Now on p 36

The scope of the report and the large number of variations in the agencies and data studied preclude making any general conclusions related to the objectives of the report To illustrate, in the first paragraph on page 41 of the conclusion you state, "the 1986 subsidy reduction had little or no effect on lenders' revenues" The discussion on pages 30 - 32 and the data in Table III.8 in Appendix III suggest. however, that the subsidy reduction may not have effected lenders' revenues because secondary markets did not have significant loan volume in their portfolios subject to the reduced subsidies A more accurate conclusion based on the information you provide would be. "The effect of the 1986 subsidy reductions cannot be determined at this time since the subsidy reduction has yet to be passed from originating lenders to secondary markets" We agree with your conclusion in the final paragraph of the conclusion on page 41 "The variations in profit levels. and the many reasons for them indicate that profitability measures do not, in themselves. provide a sound basis for determining the appropriate special allowance factor"

Dated Information

The data used to generate the analysis and draw conclusions in this report was collected

61

Page 2, Franklin Frazier, August 22, 1990

from fiscal years 1985 through 1988. A number of significant events and changes have occurred in the student loan industry since 1988 and increased the costs associated with acquiring, owning, and servicing loans. These events and changes include the UES failure, changes in regulations, and most recently, the financial difficulty of the Higher Educational Assistance Foundation (HEAF), the nation's largest student loan guarantor.

UES failure

The UES incident has created a dramatically different cost of funds structure. Due to both real and perceived risks, credit providers, particularly the Japanese banks, have made a wholesale exit from the student loan industry since 1988. As funds become less available, they become more costly. The fact that letter of credit fees have increased 30% - 40% since July, 1988 is proof of that statement. The resulting increased cost of obtaining credit facility has narrowed the already slim margins of many secondary markets and increased the need for maintaining the existing special allowance rate.

Regulation changes

Arbitrage regulations issued by the Treasury Department since fiscal year 1988 remove many of the benefits of utilizing tax exempt financing as vehicle for financing student loans. As discussed in the report, many state agencies and not-for-profit secondary markets have utilized tax exempt financing as the major source of financing student loan purchases. Typically, state agencies and not-for-profit secondary markets have accepted lower rates of return to fulfill the mandate of providing access and service to areas that for-profit lenders do not serve. The arbitrage earnings have allowed state agencies and not-for-profit secondary markets to subsidize otherwise unprofitable student loan operations and provide additional services and access to students. As the full extent of arbitrage restrictions is realized the possibility exists that not-for-profit and state agencies will have to curtail services to borrowers.

Increased due diligence regulations implemented by the Department of Education in 1988 have increased the cost of servicing and operations and, directly influenced the secondary market profitability. In light of increased servicing and operation costs, it is inconceivable that further cuts can be made in the special allowance or any other facet of the program which reduces secondary market profitability.

HEAF situation

HEAF's apparent collapse has created substantial doubt about the stability of the student loan industry. Statements by the Department of Education implying that the federal government's guarantee applies only to the guarantee agency and not the lender has caused anxiety among originating lenders, secondary markets, and letter of credit providers. To date, several letter of credit providers have expressed strong concern regarding HEAF-guaranteed loans and others have requested that subsequent purchases not include HEAF p er. As the uncertainty persists, the possibility exists that student credit providers may cease any and all involvement with student loan financing thus creating a serious access problem for students.

These three areas of change have created an operating environment quite different from that of 1985 - 1988 when your study took place. While your report provides an excellent historical perspective on the profitability of secondary markets, it should not be

Page 3, Franklin Frazier, August 22, 1990

used to predict the future or set policies governing secondary markets.

Sallie Mae

The inclusion of Sallie Mae as just another secondary market skews the report and its conclusions. The federal agency status that Sallie Mae alone enjoys and the economies of scale created by their sizable portfolio and lending powers place Sallie Mae in a totally different competitive arena. Sallie Mae's many advantages and few limitations make realistic comparisons to state or bank secondary markets impossible. The required parallels do not exist.

As perceived today, the student loan industry presents greater risk than ever to credit providers. Increased risk means increased cost of funds. Since the federal government has, through arbitrage regulations, placed a cap on return to the secondary markets, special allowance provides a way to offset those increased costs. If secondary market income is cut by decreasing special allowance payments, secondary market liquidity drops, and access is reduced.

If issued as drafted, your report has severe implications for the entire student credit industry and could result in restricted access to higher education. The conflict between the mandate of the student loan programs which is access, and the standards by which we, and other providers of those programs are increasingly judged (including profitability), is escalated by your report.

Once again, I appreciate the opportunity to comment on this draft of your report and your attention to our concerns. If you have any questions, please contact me.

Sincerely,

Don R. Bouc
President

gao3

63

Comments From Nellie Mae

The New England Education Loan Marketing Corporation

August 7, 1990

Mr. Franklin Frazier
Director, Education and Employment
Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to comment on the draft report of GAO regarding the profitability of guaranteed student loans to lenders and holders. I believe that the GAO staff has done an effective job of compiling and analyzing data provided by study participants who themselves are quite diverse in structure, financing and servicing characteristics, and portfolio composition.

The draft study clearly demonstrates how political and economic factors effect program participants in different and often dramatic ways. It is important for Congress to know that these factors are delicately balanced and, when out of balance, result in program participants, including some of the largest in the nation, suffering diminished financial returns and even losses

It is telling that four of the five non-profit secondary markets realized losses in some years, and that both commercial banks, while being profitable, achieved earnings well below those of other bank products The only consistently profitable entity was Sallie Mae, buttressed by the advantages of low cost "agency" borrowing and lower cost centralized servicing.

It is also interesting to review how fast the statutory and regulatory environment (both Department of Education and Treasury) have changed Simply over the period covered by the study we've seen:

-- Reduction in SAP yield to T-Bill + 3 25%
-- Gramm-Rudman-Hollings sequestration reduction to T-Bill + 3 1%
-- Creation, expansion and reduction of SLS program
-- Consolidation loan program
-- Department of Education strict due diligence and cure regulations
-- Private Activity Bond caps
-- Change in Plan for Doing Business approvals

50 Braintree Hill Park, Suite 300, Braintree, Massachusetts 02184-1763
617-849-1325 800-EDU-LOAN

Mr. Franklin Frazier
Page two

August 7, 1990

Further, the Treasury regulations proposed in July 1989 and effective January, 1990 including SAP within the arbitrage calculation and limiting permissible operating expenses to 2%, effectively eliminates the use of tax-exempt financing for federal student loan programs.

Material deleted, see p 37

Two minor corrections:

Now on p. 2

Page 3: the "New England Loan Marketing Association" should be "The New England Education Loan Marketing Corporation "

Now on pp. 23-24

Page 25: In 1985 and 1986 the US Department of Education was refusing to issue approvals of many "plans for doing business" submitted by non-profit secondary markets. Such approval was necessary in order to receive special allowance payments, not interest benefits, when using tax-exempt funds. To continue our secondary market support of lenders, Nellie Mae did not receive SAP on loans funded with tax-exempt bonds until the Higher Education Act was amended to transfer responsibility for plan for doing business approval from the Secretary to the Governor of the State.

Again, thank you for the opportunity to comment I hope that you will take my comments here and those submitted earlier into consideration before releasing the final report

Very truly yours,

Lawrence O'Toole

Lawrence W O'Toole
President

LWO/dms

Attachment

The New England Education Loan Marketing Corporation

Comments From the Colorado Agency

CSOBA Colorado Student Obligation Bond Authority

1981 Blake Street
Suite 201
Denver, CO 80202

(303) 295-1981
1-800-448-2424
FAX (303) 296-4811

William A. Stoltus
President

August 17, 1990

Mr. Franklin Frazier
Director
Education and Employment Issues
Human Resources Division
United States General Accounting Office
Washington, D.C. 20548

RE: Draft GAO Study Regarding Secondary Market Profitability

Dear Mr. Frazier:

Enclosed is our response to the draft of your organization's proposed report to Congress regarding the profitability of guaranteed student loans to secondary market lenders. During our review of the report draft, we did make several observations concerning the report's findings and conclusions which we would now like to submit to your office for additional consideration before the final report is issued.

Now on p. 3

Page 5 of the cover letter to Senator Kennedy states unequivocally that "The 1986 subsidy reductions had little, if any, effect on lenders' revenues." While this may be true for the period under review, we were not able to find a meaningful reference to what percentage of the study's portfolios was subject to this reduction. It would appear that, as the secondary markets continue to provide lender liquidity, and the loans within the portfolio continue to have declining balances through normal borrower repayment, the percentage of loans within the portfolio which is subject to lower subsidy will play an ever increasing part in the calculation of gross revenues as a percent of outstanding loans. Therefore, the statement quoted above should be modified to reflect its narrow application.

The report's conclusion that "variations in profitability among (secondary markets) indicate that revenue and cost information does not provide a sufficient basis for determining appropriate subsidy levels" and that a number of the agencies you investigated showed

Mr. Franklin Frazier
August 17, 1990
Page Two

losses from time-to-time suggests that there may have been insufficient scrutiny by Congress when reducing subsidy levels. These conclusions indicate that much more detailed research must be accomplished before subsidies are changed.

Bond funded secondary markets earn income from student loan interest, special allowance payments, in-school interest if the loan is purchased prior to graduation, and investment income. As opposed to the free market, secondary markets cannot adjust interest rates to meet changing market conditions. They are confined to a legislatively-mandated rate structure; normal market competitive pricing structures do not exist in this industry. Hence, secondary markets are restricted in the earning potential on a student loan.

Now on p. 3

Profitability of a secondary market hinges largely on costs. As pointed out on pages 4 & 5 of the draft, "profit variations were due primarily to differences in the lenders' financing, servicing, operating, and other costs." Financing costs depend greatly on market conditions and timing of the issue. State secondary markets exist under a restrictive state volume cap, which can affect timing of a bond issue or portfolio purchase. If timing is off, financing costs can spiral or portfolios cannot be purchased. These restrictions do not apply to Sallie Mae or banks.

Now on p 29

We ask that the reference to financing costs being related to outstanding portfolio balance be corrected to reflect the relationship to outstanding DEBT (Page 33). The ability to be cost effective in issuing debt is hindered by state volume cap restrictions. Colorado would prefer to offer fewer, larger bond issues and access the financial markets with the obvious economies of scale, however, current volume caps on tax exempt issues make this impossible.

Servicing costs have recently been escalating because of federal due diligence requirements. The study used data prior to the impact of the new due diligence regulations rendering the finding somewhat out of date already. The Office of Education has found technical violations of due diligence in almost every secondary market and servicer, the cost implications of which are unknown at this time. Also, those secondary markets using third-party servicing cannot directly control these servicing costs.

67

Mr. Franklin Frazier
August 17, 1990
Page Three

This essentially leaves operating costs as the major control factor in "costs". For most organizations, this cost is a very small proportion of overall costs, much smaller than financing or servicing costs. Thus, state secondary markets are faced with a situation where cost control, to a large degree, is not directly under their influence.

Now on p 5

Now on pp 18 and 5

The report's heading statement on page 7 ("Loans financed with tax exempt funds can be more profitable than others".) is very misleading. The study defines profitability as gross revenues less costs (page 17). What is being said on page 7 is that tax exempt financed loans may, UNDER CERTAIN MARKET CONDITIONS, earn a higher special allowance (revenue) than loans financed by other means. Profitability includes costs; the report's statement does not and is a major disservice to state secondary markets which use tax exempt financing. If this referenced statement is to remain part of the report, it should read as follows:
"Loans financed with tax exempt funds may, under certain market conditions, generate more in revenue than other loans." If the term "profitability" is used, then costs must be included.

Now on p 22

As Colorado is a non-profit, state secondary market, we find of particular interest the report's statement that for-profit secondary markets were consistently profitable (page 23), while also stating that those agencies which use tax exempt financing included some of the least profitable of the agencies studied. State secondary markets are under far more restrictions in terms of the markets they must serve. Enacting legislation requires we provide liquidity to all lenders for all eligible loans (guaranty still in effect, certain geographic requirements of either the borrower or the school etc.). The result is we frequently purchase and service the highest risk loans, without any off-setting compensation derived from increased subsidy (normal credit environments provide an increased rate of return for increased risk).

Material deleted, see p 37

Mr. Franklin Frazier
August 17, 1990
Page Four

We appreciate the opportunity to comment on the GAO report draft and sin :ely trust our concerns will be seriously addressed prior to the i al report being issued. Please feel free to contact me or my staff should you have any questions regarding our comments.

Sincerely,

William A Stolfus

William A. Stolfus
President

69

Comments From the Pennsylvania Agency

PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

660 BOAS STREET
HARRISBURG, PENNSYLVANIA 17102 1398

August 31, 1990

Mr. Franklin Frazier
Director, Education and
Employment Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Frazier:

This is in response to your letter of July 19, 1990 concerning PHEAA's comments on the draft report of the GAO regarding the profitability of guaranteed student loans to lenders and holders.

A review of the draft report clearly indicates that GAO's staff has done a very good job of compiling and analyzing data provided by the ten participants in the study which demonstrate quite a diverse approach to providing capital for secondary market purposes.

Although PHEAA does hold approximately $40 million in Stafford loans purchased from various lenders, the statutory and public purpose is served by making loans for postsecondary education purposes to Pennsylvania residents at or below market rate levels to provide middle income families with a moderate cost source of credit to fund the costs of postsecondary education. To accomplish this goal, PHEAA must:

a. Finance at tax-exempt rates.

b. Subsidize the tax-exempt financings via an issuer contribution valued at five to ten percent of the face amount of the financing.

c. Administer the direct loan program, including loan origination and servicing within the limitations of cost recovery mechanisms controlled by the allowable spread inherent in tax-exempt financing.

d. As Stafford loan eligibility continues to become less of a reality for the middle and upper income family, the need for PHEAA to meet this increasing demand for direct loans and the PHEAA "secondary market" activity is of the utmost importance and our program is not driven by concerns of profitability or competition.

Because of the unique role of PHEAA, staff believes the Agency should be excluded from this secondary market report or placed in a separate category for the purposes of the report.

- 2 -

Also, it is important that the final report makes it clear to Congress that political and economic factors directly affect the administration of each of the program participants and these factors need to be considered before legislative changes are made. This is clearly evident when you look back at the numerous changes on both the statutory and regulatory level that have taken place which greatlv impact on profitability of student loans to not only secondary markets but also direct lenders and guaranty agencies.

Thank you for the opportunity to comment, and I will be looking forward to reviewing the final report.

Sincerely,

Thomas R. Fabian
Executive Deputy Director

TRF:mbm
TF4.99900831/03

71

Major Contributors to This Briefing Report

Human Resources Division, Washington, D.C.

Joseph J. Eglin, Jr.. Assistant Director, (202) 401-8623
William A. Schmidt, Advisor

Seattle Regional Office

Charles M. Novak, Evaluator-in-Charge
Benjamin P. Pfeiffer, Evaluator
Susie Anchell, Evaluator
Keith C. Martensen, Evaluator

Appendix 16

END

U.S. Dept. of Education

Office of Education
Research and
Improvement (OERI)

ERIC

Date Filmed

March 29, 1991